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No. 112

IN THE

Supreme Court of the United States

OCTOBER TERM, A. D. 1927.

AETNA INSURANCE COMPANY, AGRICULTURAL INSURANCE COMPANY, ALLIANCE INSURANCE COMPANY OF PHILADELPHIA, et al.,
Petitioners,

vs.

BEN C. HYDE, Superintendent of the Insurance Department of the State of Missouri,
Respondent.

BRIEF FOR PETITIONERS.

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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, A. D. 1927.

AETNA INSURANCE COMPANY, AGRICULTURAL INSURANCE COMPANY, ALLIANCE INSURANCE COMPANY OF PHILADELPHIA, et al., *Petitioners,* vs. BEN C. HYDE, Superintendent of the Insurance Department of the State of Missouri, *Respondent.*	No. 112

BRIEF FOR PETITIONERS.

The majority and minority opinions below are reported in *Aetna Insurance Company* v. *Hyde*, 285 S. W. Rep. 65, and are printed at pages 3003-3046 of the record herein.

This Court has jurisdiction.

The petitioners, comprising all of the stock fire insurance companies doing business in Missouri (R. 1633, 1919), brought suit in the Circuit Court of Cole County, Missouri, to review a rate reduction order of the respondent Superintendent of Insurance. The suit was a review proceeding authorized by statute. Upon appeal the Supreme Court of Missouri, the highest court of the state in which a decision could be had, rendered judgment on May 21, 1926 (R. 3000), sustaining the rate reduction order. The judgment became final on June 23, 1926. (R. 3075).

Petitioners attacked the rate reduction order as in violation of the due process clause of the Fourteenth Amendment, in that the same is unreasonable and confiscatory, and the methods adopted and findings made in the calculation of petitioners' profit or loss in Missouri for the statutory five-year test period (Sec. 6283, R. S. Mo. 1919) are unreasonable, capricious, fundamentally erroneous and confiscatory and operate to deprive petitioners of their property without due process of law, in these respects:

(*a*) In ascertaining the amount of petitioners' profit or loss, $8,688,365 of premiums which were not earned during the test period are included as income, and $1,162,959 of incurred but unpaid losses and expenses are excluded from consideration as outgo (R. 3034-5, 3007-8). This action and method of calculation were attacked as confiscatory and as a denial of due process (R. 33, 35, 2995-8, 3048-9, 2884-6), but were upheld by the opinion below (R. 3017-23).

(*b*) Although all premiums received, both earned and unearned, are treated as income, and such unearned premiums are treated as the unqualified property of the petitioners (R. 3017-23, 3044-6), nevertheless $2,301,132 interest derived from the investment of such unearned premiums is also included as underwriting income (R. 3034-5); and thereby earnings from one department of petitioners' business (investment) are applied to a reduction of rates in a separate and distinct department (underwriting). The earnings of the underwriting business, that is, the operating returns, are insufficient to pay the cost of the underwriting, that is, the operating outgo. There is already a deficit in operation, and a reduction of rates cannot be justified by any reference to investments or return from investments. Petitioners attacked this method of calculation as unreasonable and confiscatory and as a denial of due process (R. 33, 35, 590-1, 595-6, 599-600, 372-7, 400-2, 463-4, 468, 469, 491-2, 563, 608-9, 611-13, 614-18, 620-

662, 2043, 2047-9, 2052, 2216-17, 2263-4 2880, 2884-6, 2987-92, 3054-5); but the opinion below nevertheless approved it (R. 3023-8, 3075).

(*c*) The sum of $2,496,715 so-called excess commissions to St. Louis agents (being commissions based on scale higher upon the average of all companies than that obtaining in the remainder of the state) is excluded from expense as unreasonable (R. 3032-3), notwithstanding said expense was actually incurred and paid in good faith as a necessary operating expense. This ruling was attacked by petitioners as an infringement of their inherent right to manage their own business according to their own best judgment, and as a denial of due process (R. 34, 37, 3216-17, 2264, 2993-5, 2986, 3055-7), but the contention was disallowed (R. 3032-3, 3075).

(*d*) The sum of $628,123 Federal war tax on Missouri premiums is excluded from consideration although that sum was actually incurred and paid as a necessary operating expense. This ruling was attacked as unreasonable and confiscatory and as a denial of due process (R. 34, 37, 2986, 2993-5, 3056), but the contention was disallowed (R. 3034-5, 3075).

(*e*) The decision fixes 8% of premiums received, or $6,680,169, as a reasonable profit. The allowance of this amount as a supposed profit, having its basis in the unconstitutional considerations mentioned in (*a*) to (*d*), *supra*, is unreasonable and confiscatory. It also fails to make any allowance for reserves; and in view of the fact that petitioners were compelled by the laws of Missouri to set aside $12,717,006 as the average amount of reserves during the test period (60% of which, or $7,630,209, was drawn from premiums received) the standard of profit fixed by the opinion is unreasonable and confiscatory. This contention was made below (R. 3048, 3060) and was disallowed (R. 3034-5, 3075).

(*f*) The rating act (Sec. 6283, R. S. Mo. 1919) as construed and applied by the opinion below is confiscatory and deprives

petitioners of their property without due process of law. This point was presented below (R. 35, 37, 621-2, 2216-17, 2263-4), and by the result of the decision was necessarily disallowed (R. 3034-5).

The foregoing propositions involve Federal questions of substance not heretofore determined by this court, and are of vital importance in Missouri and numerous other states having statutes authorizing the regulation of insurance rates. The court below has decided the questions in a way not in accord with applicable decisions of this court upon analogous questions.

Petitioners base their petition for certiorari upon Sec. 237 (*b*) of the Judicial Code as amended by the Act of February 13, 1925.

The following decisions sustain the jurisdiction of this court to review the judgment below:

Bluefield Company v. *Public Service Commission*, 262 U. S. 679.

Northern Pacific Ry. Co. v. *Department of Public Works*, 268 U. S. 39.

Chicago, Milwaukee & St. Paul Ry. Co. v. *Public Utilities Comm.*, 47 S. C. Rep. 640, l.c. 606.

Southern Railway Co. v. *Commonwealth*, 47 S. C. Rep. 542.

Southwestern Telephone Co. v. *Public Service Commission*, 262 U. S. 276, l.c. 288-289.

Myles Salt Co. v. *Iberia Drainage District*, 239 U. S. 478, l.c. 484.

Ohio Utilities Co. v. *Public Utilities Commission*, 267 U. S. 359.

Vandalia Railroad Co. v. *Schnull*, 255 U. S. 113.

Brooks-Scanlon Co. v. *Railroad Commission*, 251 U. S. 396.

Georgia Railway & Power Co. v. *Railroad Commission of Ga.*, 262 U. S. 633.

Galveston Electric Co. v. *Galveston*, 258 U. S. 388, l.c. 399-400.

Interstate Commerce Commission v. *Union Pacific Railroad Company*, 222 U. S. 541, l. c. 547.

Union Tank Line Company v. *Wright*, 249 U. S. 275.

Northern Pacific Ry. Co. v. *North Dakota*, 236 U. S. 585.

Smyth v. *Ames*, 169 U. S. 466, l.c. 540-541.

Minnesota Rate Cases, 230 U. S. 352.

Norfolk & Western Ry. Co. v. *Conley*, 236 U. S. 605.

Board of Public Utilities Commissioners v. *New York Telephone Co.*, 271 U . S. 23.

Houston v. *Southwestern Telephone Co.*, 259 U. S. 318, l.c. 323.

Banton v. *Belt Line Railway*, 268 U. S. 413, l.c. 421.

STATEMENT OF THE CASE.

Certiorari to review a judgment of the Supreme Court of Missouri, which by a divided court sustained an order of the Superintendent of the Insurance Department of Missouri (effective Nov. 15, 1922) reducing rates of stock fire insurance companies ten per cent. The opinions below are reported in *Aetna Insurance Company* v. *Hyde*, 285 S. W. 65. This court granted certiorari under Section 237B of the Judicial Code as amended by the Act of February 13, 1925 (47 Sup. Ct. Rep. 113).

This case presents federal questions of fundamental importance in the regulation of fire insurance rates by the several states. Its pecuniary importance is indicated by the fact that the 10% reduction involved herein amounts to more than $1,500,000 per year, and that if the judgment below is permitted to stand, petitioners, (having collected the old rate

pending the suit under the security of indemnity bond), will be compelled to return to Missouri policyholders approximately $8,000,000 as refund of premiums collected.

The petitioners, 157 in number, comprise all of the stock fire insurance companies licensed to do and doing business in Missouri (R. 1633, 1919). Respondent is the Superintendent of the Insurance Department of that state.

The case presents for review an order of the Superintendent promulgated October 9, 1922, effective Nov. 15, 1922, directing a reduction of 10% in rates charged by petitioners (R. 27-31, 40). Petitioners brought suit in the Circuit Court of Cole County, Missouri, for a judicial review of the order. The Superintendent appeared to the suit and filed his answer. Issues being formed, the case was referred to a referee. After extended hearings he found the order unreasonable and confiscatory. His report was confirmed by the trial court, and judgment was rendered in petitioners' favor, setting aside the rate order in its entirety. Such judgment was reversed and the proceeding ordered dismissed by the Supreme Court of Missouri, which held the reduction order justified (R. 3003). A dissenting opinion was filed, concurred in by two judges, holding the order confiscatory and in violation of the due process clause of the Fourteenth Amendment (R. 3037). It is to review the judgment of the Missouri Supreme Court that this proceeding is filed.

The rating statute under which the Superintendent purported to act in making his order is as follows (Sec. 6283, R. S. Mo. 1919):

> "Sec. 6283. Superintendent to investigate the reasonableness of rates—authority to order reductions.—The superintendent of insurance, upon written complaint of any citizen, or upon his own motion, is hereby empowered to investigate the necessity for a reduction of rates, and if, upon such investigation, it appears that the result of the earnings in this state of the stock fire insurance companies for five years next preceding such investigation

shows there has been an aggregate profit therein in excess of what is reasonable, he shall order such reduction of rates as shall be necessary to limit the aggregate collections by insurance companies in this state to not more than a reasonable profit. Any reduction ordered by the superintendent of insurance shall be applied, subject to his approval; Provided, that the superintendent of insurance shall designate the class or classes to which the reduction shall be applied if the companies do not, within thirty days from the order of reduction, submit a class or classes which meet his approval. In determining the question of rates and profits in accordance with this article, the superintendent of insurance shall give proper and reasonable consideration to the conflagration liability, both within and without the state. (Laws 1915, p. 313).

The review proceeding instituted by petitioners was brought pursuant to Section 6284, R. S. Mo. 1919, reading as follows:

> "Sec. 6284. Order of superintendent reviewable by court action.—The orders and directions of the superintendent of insurance, together with his findings or determinations of facts upon which such order or determination is founded, shall be reviewable by a proper action in the courts, and upon such review the entire matter shall be treated and determined *de novo*, but the burden of proof as to the unreasonableness or the injustice of any order made by the superintendent of insurance shall rest upon the party or company appealing from any such order. During the pendency of such action or review each insurance company or other insurer shall not charge any rate or premium in excess of that fixed by the superintendent of insurance. (Laws 1915, p. 313.)"

The petitioners have established agencies in the State of Missouri at great cost. Petitioners' agency relations, good will and established business are of great pecuniary value. (R. 749, 1531-2, 1760-1, 1800, 1802-3.) If the superintendent's order should be sustained, petitioners must either conduct their business in Missouri at rates which they contend are grossly inadequate and confiscatory and will deprive them of all profit, or alternatively they must abandon their Missouri

dence from petitioners' books and records. The discrepancies in such reports therefore do not affect the result herein. Incidentally, it is but fair to add that defects therein were not due to wrongful intent on the part of petitioners, but were due to the confessedly incomplete, ambiguous and confusing form in which the report blanks themselves were prepared by the Insurance Department. Some companies reported on one basis and some on another. (R. 1855-1908, 196-7, 380-6, 387-393, 443-6, 535-6, 603-7, 668-9, 675, 2083-5, 2273.)

The petitioners contended that their profit or loss during the test period must be calculated on the basis of premiums *earned* less losses and expenses *incurred*. The opinion concedes (R. 3018) that on this basis petitioners sustained an underwriting loss of $7,010,200 during the test period, as follows (R. 3007):

Earned Premiums		$74,813,816
Incurred Losses	$48,593,664	
Incurred Expenses	33,230,352	
Incurred losses and expenses combined		81,824,016
Underwriting loss (9% of earned premiums)		$ 7,010,200

The opinion, however, rejects the earned and incurred method and holds that the calculation must be upon the basis of premiums *received* less loss and expenses *paid*, and must include interest on unearned premiums as underwriting income, and that certain expenses in fact incurred and paid must be eliminated from computation in a rate hearing.

The opinion says (R. 3034-5):

"We summarize our conclusions as follows:

Premiums (received) 1917-1921	$83,502,181
Add interest on unearned premium	2,301,132
Total income	$85,803,313

Losses and Expenses (Paid)		$80,161,057	
Deduct			
Excess commissions in St. Louis	$2,496,715		
Federal income tax	542,993		
	$3,039,708	3,039,708	
Actual loss and expense		$77,121,349	77,121,349
Actual net earnings			$ 8,681,964
If the war tax had not been in operation			628,123
it would have been			$ 9,310,087
If the increase of 1920 had not been in partial effect			1,084,444
the net earnings would have been			$ 8,225,643"

The court finds that the rate order would produce a reduction of income of $7,134,751. (R. 3036.)

It is a noteworthy fact that upon the figures adopted by the opinion below, the rate reduction order is sustained by the narrow margin of $607,040. That is to say, the opinion finds that, *after applying the ten per cent reduction* the petitioners on the volume of business in the test period would earn a profit of $7,287,209 (R. 3036), and that a reasonable profit on that volume of business would be $6,680,169 (R. 3035). Therefore the profit which the opinion says petitioners would earn with the reduction applied is only $607,040 in excess of the amount which the opinion finds would have been a reasonable profit. Each of the items complained of by petitioners involves more than $607,040. The net result is that if any one of petitioners' contentions is sustained, the rate reduction order is demonstrably confiscatory.

The terms employed herein are doubtless familiar to the court. To guard against misunderstanding, we beg, nevertheless, to define some of the words according to the sense in which they are employed herein.

Definitions.

By the "*earned premiums*" of a given test period, when the term is used respecting a group of policies, is meant that part of the premiums of all policies in force during any part of such period under computation as pays for insurance during such time. Respecting policies the terms of which are partly within and partly without such period under calculation, the pro rata portion of the premiums provided in such policies which pays for insurance during such period is taken into account rejecting from consideration the portion which pays for insurance before or after such period under calculation. Such prorating is made dependent upon the proportion of the term, stipulated in the policies, which is within the period under calculation; thus, a policy, half of the term of time of which is within the period under computation and half outside of that period, has half of its premium assigned to the period being computed.

The earned premium considered includes not only premiums derived from policies written during the test period and in force during such period, but also pro rata premium upon all policies written *prior* to the test period remaining in force during such test period, or part of it.

The test period in the case at bar was the period 1917 to 1921 inclusive. A policy written on January 1, 1917, for a period of five years, and remaining in force through that whole period, would have its entire premium earned during that period. A policy for five years, which went into force on January 1, 1918 and was still in force at December 31, 1921, would have four-fifths of its premium applied to the test term. A policy for five years, written on January 1, 1914

and remaining in force until it expired by its terms, would have two-fifths of its premium earned in the test period because three of the five years, for which the premium paid, expired before January 1, 1917, and two years of such term were during the test period.

By the "*incurred losses*" of such test period is meant those losses from perils insured against which happened during such test period, and includes all of the losses occurring during the five-year period, 1917 to 1921, inclusive, under policies then in force, whether such losses were paid or not paid by December 31, 1921.

By the "*incurred expenses*" of such test period is meant the operating expenses in conducting such business, for which the liability of the insurance companies became fixed during such test period, whether or not such fixed liability was discharged by December 31, 1921.

By the "*premiums received*" during such test period is meant the premium stipulated in the policies written during such period, making no distinction between the premiums upon policies wholly within the test period and those which by their terms extend beyond the test period. (Premiums written and premiums received are not in fact, identical. The Supreme Court of Missouri has dealt with them as if they were. The difference is not important in this case, so we treat them as identical.)

By the "*losses paid*" during such test period is meant the loss payments made during such period, regardless of whether such losses occurred during the period from January 1, 1917 to December 31, 1921, or whether they had happened prior to that time, and regardless of whether such losses did or did not arise upon policies in force during such period.

By the "*expenses paid*" is meant the amount of expenses paid during such test period, whether the liability for them became fixed during such period or at an earlier time, and

disregarding expenses for which liability existed during the period, which have not been actually discharged before the termination of the period.

Federal questions.

The *federal questions* presented are as follows:

(*a*) The petitioners attacked as confiscatory the method of calculating underwriting profit adopted by the rate reduction order and the decision below. The order and the decision make the calculation upon the basis of premiums *received* less losses and expenses *paid*, instead of upon premiums *earned* less losses and expenses *incurred*, during the test period. The amount of premiums received upon policies written during the test period was $83,502,181 (R. 3034); but only $74,813,816 was earned during the test period (R. 3007, and see plaintiff's Exhibit 1359 at R. 1925), leaving a balance of $8,688,365 of premiums received but not earned during the test period.

Insurance policies are usually written for terms of one, three or five years (R. 251, 206), the average term being two years and seven months. The premium is payable at the beginning of the term (R. 206). A portion of the premium must under the laws of Missouri be immediately set aside in a reserve, denominated the "unearned premium reserve," this portion being fixed by statute at "50% of the gross premiums on all unexpired fire risks that have less than one year to run, and a *pro rata* of all gross premiums on risks that have more than one year to run" (Sec. 6222, R. S. No. 1919, printed in appendix hereto).

The unearned premium reserve is a prepaid premium which pays for indemnity and service for a future term. It must be reserved to take care of future losses and expenses on the policy, or the return of unearned premium in case of cancellation (R. 843, 889-90, 211, 359, 362-3, 697-8, 732, 803, 804-5, 1533, 1630, 1955, 2120). As time goes on, more and more of

the premium received upon a specific policy becomes earned, and less of it remains unearned, until at the expiration of the policy (or upon payment of a total loss) it all becomes earned (R. 704, 706, 209-10, 230, 477-8).

The method adopted in the opinion below is to include as income all premiums received regardless of whether entirely earned during the test period or not. In point of fact $8,688,-365 of the premiums received were admittedly not earned during the test period, and at the expiration of the period constituted part of the unearned premium reserve.

Petitioners' losses and expenses *paid* in the test period were $80,161,057 (R. 3034-35), but their losses and expenses incurred were $81,824,016 (R. 3007, and see plaintiff's Exhibit 1359, at R. 1925). So at the end of the period there was a balance of $1,662,959 of incurred but unpaid losses and expenses, namely, for which fixed liability existed, which liability had not yet been discharged. Petitioners' liability for this balance of losses and expenses was firmly fixed and established during the test period (R. 1036-38, 1386, 1507). The decision below excluded this sum from outgo, and based the ascertainment of profit upon losses and expenses *paid*.

The difference between *expenses* incurred and *expenses* paid is negligible (it is otherwise as to losses), because expenses are paid substantially as they are incurred (R. 3019, 708, 765). As a matter of convenience a few companies calculate their experience for their own purposes on a paid basis so far as *expenses* are concerned (R. 307, 722, 1191). However, the difference between *losses* incurred and *losses* paid may in a given period be substantial and this difference may be either way, depending upon the experience of the last sixty days of the period (R. 236). Losses are payable sixty days after proof of loss (R. 236, 1248, 1621, 1804-6). If during the concluding sixty days of a given period a relatively larger number of losses occur and are adjusted than were carried over unpaid from the last 60 days of the immed-

diately preceding term (so that although not paid, liability therefor is fixed) then the incurred losses would exceed the paid losses. In the particular test period here in question the Missouri incurred losses were greater in three of the five years, and less in the other two years, than the paid losses (Plaintiff's exhibits 1359 and 1361 at R. 1925 and 1934).

Numerous expert witnesses of many years experience testified that underwriting profit or loss can only be ascertained by deducting from earned premiums the incurred losses and expenses (R. 831-3, 837, 959, 209, 181-2, 216-17, 227-8, 666-7, 698-9, 711, 420-1, 1173-4, 1206, 1310, 1486, 1505-6, 1536-7, 1604, 1667, 1687, 1782-3, 1787). A calculation upon the basis of premiums received less losses and expenses paid (producing what is called a "trade balance") does not disclose profit or loss because it ignores the necessity of a reserve to care for the obligations of unexpired policies and existing liabilities. (A. 209, 195-6, 708-9, 764, 766, 806, 182, 959-60, 1506, 1660); and a calculation of experience of an insurance company on the received and paid basis might cause it to appear prosperous, yet when taking into account the required reserve, the company might be actually insolvent (R. 837-8, 864-5, 2142, 2796, 2284-5).

It is now and has been for a great many years the *universal practice* in the insurance business to calculate underwriting profit upon the earned and incurred basis, and not upon the received and paid basis (R. 3045, 959, 1538, 228, 233, 863, 1310, 1359, 1369-70, 1459, 1504, 1660). The earned and incurred method is used by all insurance companies for their own profit calculations, for purposes other than rate making as well as rate making, and is universal in the business (R. 3045, 863, 228, 754, 1359, 1426, 1428, 1504, 1516, 1532-3, 1538).

"The National Convention of Insurance Commissioners" of the several states (a voluntary association of which the Superintendent of Insurance of every state in the Union is a member) have after several years of investigation formulated

the rule that "underwriting profit (or loss) is arrived at by deducting from earned premiums all incurred losses and incurred expenses." (R. 831, 1371).

Congress in imposing taxes upon income of insurance companies prescribed that the term "underwriting income means the premiums earned on insurance contracts during the taxable year, less losses incurred and expenses incurred" (Sec. 246 of Revenue Acts of November 23, 1921, June 2, 1924 and February 26, 1926, printed in appendix hereto, R. 864, 876).

By statutes of Missouri (printed in the appendix hereto) the insurance companies are compelled to set aside the unearned portion of their premiums in a reserve (Sec. 6222, R. S. Mo. 1919), and are prohibited from paying dividends except from "surplus profits" (Sec. 6333, R. S. Mo. 1919). The method prescribed by statute (Section 6222, R. S. Mo. 1919) for determining surplus profits is by offsetting against assets all current liabilities, including unearned premiums (R. 1277). The payment by an insurance company of dividends out of unearned premiums would be a violation of the Missouri statutes. The opinion below nevertheless treats $8,688,365 of unearned premiums as "earnings."

The insurance companies are required to make annual statements to the Superintendent upon blanks provided by him, which blanks are in a form prepared by the National Convention of Insurance Commissioners and are familiarly designated as the "convention form of annual statement blank." On one page of the blank the companies are required to show their nationwide underwriting profit or loss. The basis there prescribed is that of premiums earned less losses and expenses incurred (R. 187-190, 863, 228, 232, 709, 1371, 1536-7, 2141-2, 2204, 2295, 2806-7.)

Petitioners have throughout contended that the calculation of underwriting profit or loss upon the received and paid basis, instead of upon the earned and incurred basis, is un-

reasonable, arbitrary and fundamentally erroneous, and that the reduction of rates based thereon is confiscatory and a denial of due process (R. 33, 35, 2995-8, 3048-9, 2884-6). This contention was disallowed. (R. 3017-23.)

(*b*) Not only does the opinion below include as income all premiums received, thereby treating unearned premiums as the unqualified property of petitioners, but in addition to this includes as underwriting income for rate-making purposes the sum of $2,301,132, stated by the opinion to be interest on unearned premiums (R. 3023-28, 3034-5). Thereby interest derived from the investment of petitioners' assets (recognized by the majority opinion to be their unqualified property) is applied to a reduction of rates for underwritng.

Petitioners have two separate and distinct activities or departments of their business, (1) underwriting and (2) investments, each being independently productive of a profit or a loss (R. 1530, 745, 770, 823, 842, 959, 989-90, 1320-2, 2848). The opinion takes income from one department (investment) and applies it to a reduction of rates for service in another department (underwriting). The first inquiry in any rate case is, and must be, respecting the operating account to find whether the operating income is adequate to meet outgo. The effect of this holding is to require petitioners to do their underwriting business at rates of premium which will result in an operating loss, or yield less than a reasonable profit, on the theory that by the application of interest earnings such loss or deficiency in operating profit may in whole or in part be overcome. Petitioners attacked this theory as confiscatory (R. 33, 35, 590-1, 595-6, 599-600, 372-7, 400-2, 463-4, 468, 469, 491-2, 563, 608-9, 611-18, 620-662, 2043, 2047-9, 2052, 2216-17, 2263-4, 2880, 2884-6, 2987-92, 3054-5), and the contention was disallowed (R. 3023-8, 3075).

In the dissenting opinion petitioners' present contention is approved, and the view is expressed that if the received

and paid basis be adopted, then interest earnings from unearned premiums cannot be included as income without invading petitioners' constitutional rights (R. 3044-6).

(*c*) In the calculation designed to show profit for the test period, the decision below deducts from petitioners' expenses $2,496,715 excess commissions (commissions paid by petitioners to their St. Louis agents upon a higher average scale than that in force elsewhere in Missouri). This deduction is based upon the ground that the lack of uniformity and higher expense in St. Louis was proof that such excess commissions were unreasonable expenses (R. 3032 5).

The excess commissions were a necessary part of petitioners' expenses, incurred and paid in good faith. St. Louis agents, by reason of the higher cost of operating agencies in that city as compared with the cost in the rest of the state, and because of additional service rendered by them, have for many years exacted from petitioners a higher scale of commissions than are paid elsewhere in the state. These increased commissions are expenses which, according, to the best judgment and discretion of petitioners' respective officers, are reasonable, and which petitioners are compelled to pay if they wish to do business in St. Louis. This expense is forced upon petitioners by competition (R. 772, 1741, 1770-2, 1778, 785, 1610-11, 725, 1557, 1481-3, 1767). While petitioners by the laws of Missouri must write business at uniform rates there is nevertheless keen competition between them in the acquisition of business and creation of desirable brokerage and agency connections.

Petitioners contended below that the Superintendent cannot constitutionally be permitted to substitute his judgment for the discretion of the petitioners respecting the necessity and reasonableness of this expense; and that to hold otherwise is to invade the inherent right of petitioners to conduct their own business in their own way, and to deprive them of their

property without due process (R. 34, 37, 2216-7, 2264, 2986, 2993-5, 3055-7). The contention was disallowed (R. 3032-3, 3075.)

(*d*) In determining whether the ten per cent reduction in rates was reasonable, the decision below (R. 3034-5) deducted from petitioners' expenses during the test period the sum of $628,123 Federal war tax on Missouri premiums (imposed by Secs. 504-5 of Act of October 3, 1917; Sec. 503 (*b*) of Act of February 24, 1918; war tax repealed by Sec. 1400 of Act of November 23, 1921). The war tax was a necessary operating expense. Petitioners were compelled to pay it, and did pay it, as a necessary incident to their doing business in Missouri (R. 405, 411, 214, 529, 1952). The rejection of this item was attacked as confiscatory (R. 34, 37, 2986, 2993-5, 3056), and the point was disallowed (R. 3034-5, 3075).

(*e*) The decision below held that 8 per cent of $83,502,181 premiums received, or $6,680,169, would be a reasonable profit to petitioners for the test period (R. 3035). In adopting this standard no provision was made for unearned premium reserve which petitioners are compelled by law to set aside (Sec. 6222, R. S. Mo. 1919) nor for other elements necessary to state a just account. The average or mean unearned premium reserve for the test period was $12,717,016 (see Plaintiff's Exhibit 1359 at R. 1925), or substantially twice the amount of the reasonable "profit" fixed by the opinion below. Sixty per cent of the unearned premium reserve is drawn from premiums received, and the remaining forty per cent from free surplus (R. 838-9, 964, 1541-2).

The opinion below states that "a reasonable profit, it seems to be agreed, is 5 per cent on the underwriting business done, with 3 per cent additional for conflagration hazard" (R. 3011). This is not an accurate statement of the record. Petitioners' evidence as to the amount of a reasonable profit is that 8 per cent of premiums earned ($74,813,816), or $5,985,-

105, would be a reasonable operating profit (R. 983, 719, 771, 832, 851, 1176, 1230, 1487, 1547, 1693-4). This measure of profit, however, was based upon a calculation of underwriting profit or loss by the earned and incurred method (R. 851, 1231, 1693-4), under which method the unearned premium is set up as a liability and the balance used as the income factor in profit calculation.

The opinion below fixed 8 per cent of premiums received, or $6,680,169, as the amount of a reasonable profit on the business of the test period, but entirely disregarded the fact that an amount in excess of that sum, set aside out of premiums received to make up the unearned premium reserve, more than consumed the entire "profit" allowed. The basis taken also fails to reserve any amount for loss liabilities owing but unpaid. Petitioners contended that in these respects the standard of profit fixed by the opinion is founded upon a fundamentally erroneous basis, and is confiscatory (R. 3048, 3060), and the contention was disallowed (R. 3075).

(*f*) Petitioners further contend below that the rating act (Sec. 6283, R. S. Mo. 1919), as now construed and applied is unconstitutional upon each of the grounds assigned in the attack upon the rate reduction order. Petitioners do not attack the constitutionality of the statute as written, but attack its constitutionality as construed and applied in the instant case (R. 35, 37, 621-22, 2216-7, 2263-4).

All of the foregoing Federal questions were specially asserted by petitioners at the earliest possible stage, and were kept alive throughout the proceedings below. They were asserted in the original petition, objections to evidence, briefs and motion for rehearing (R. 31-2, 33-5, 37, 328, 372-7, 397-8, 400-2, 439-40, 463-4, 467-9, 472-3, 557, 563, 575-6, 590-1, 595-6, 599-600, 608-9, 611-18, 620-662, 491-2, 2043, 2047-9, 2052, 2216-7, 2263-4, 2880, 2986-99, 2047-9, 3054-7). The effect of the majority opinion is to deny each of them.

Specification of errors.

1. The Missouri Supreme Court erred in adopting the received and paid method of calculating underwriting profit, instead of the earned and incurred method, and in thus including as income $8,688,365 of unearned premiums and rejecting as outgo $1,662,969 of incurred losses and expenses; and thereby adopted an unreasonable, fundamentally erroneous and confiscatory method of calculation, which deprives petitioners of their property without due process of law, in violation of Section 1 of the Fourteenth Amendment of the Constitution of the United States.

2. The court erred in applying $2,301,132 interest earnings from invested assets to a reduction of rates for underwriting, and thereby adopted an unreasonable and confiscatory method of arriving at petitioners' profit or loss from underwriting, by which petitioners are deprived of their property without due process of law, in violation of Section 1 of the Fourteenth Amendment of the Constitution of the United States.

3. The court erred in deducting from petitioners' expenses $2,496,715 commissions paid to their St. Louis agents, and thereby adopted a method of arriving at petitioners' profit or loss which is unreasonable and confiscatory, depriving petitioners of their property without due process of law, in violation of Section 1 of the Fourteenth Amendment of the Constitution of the United States.

4. The court erred in rejecting from petitioners' expenses $628,123 war tax on premiums, and thereby adopted a method of arriving at petitioners' profit or loss which is unreasonable and confiscatory, depriving petitioners of their property without due process of law, in violation of Section 1 of the Fourteenth Amendment of the Constitution of the United States.

5. The court erred in fixing 8 per cent of premiums received, or $6,680,169, as a reasonable profit upon the business of the test period, and in failing to make allowance for proper elements of income and outgo, and for the unearned premium reserve, and in ignoring the fact that the amount of premiums received which petitioners were required to set aside in the unearned premium reserve more than consumed the entire "profit" allowed; and thereby the court adopted an unreasonable, fundamentally erroneous and confiscatory standard of profit, by which petitioners are deprived of their property without due process of law, in violation of Section 1 of the Fourteenth Amendment of the Constitution of the United States.

6. The court erred in holding the rating statute (Section 6283, R. S. Mo. 1919) as construed and applied to be constitutional whereas said statute as construed and applied by the court is in violation of Section 1 of the Fourteenth Amendment, in that it deprives petitioners of their property without due process of law.

SUMMARY.

I.

The rate reduction order of the Superintendent of Insurance was made upon a calculation of petitioners' profit or loss for the test period upon the basis of premiums received less losses and expenses paid, instead of upon the basis of premiums earned less losses and expenses incurred. The basis so adopted is fundamentally erroneous, unreasonable and confiscatory.

By the received and paid method $8,688,365 of premiums which were not earned during the test period are included as accrued income, and $1,662,959 of losses and expense which were actually incurred during the test period are rejected as outgo. This is unreasonable and fundamentally erroneous.

Bullion v. *Aetna Ins. Co.*, 151 Ark. 519.

Sun Insurance Office v. *Clark*, App. Cas. L. R. 1912, 443. (House of Lords).

Northern Pacific Ry. v. *Department of Public Works*, 268 U. S. 39, l.c. 44-45.

Chicago, Milwaukee & St. Paul Ry. Co. v. *Public Utilities Commission of Idaho*, 47 Sup. Ct. Rep. 542.

Southern Ry. Co. v. *Commonwealth*, 47 Sup. Ct. Rep. 542.

Ohio Utilities Company v. *Public Utilities Commission*, 267 U. S. 359.

Interstate Commerce Commission v. *Union Pacific Railroad*, 222 U. S. 541, l.c. 547.

Bluefield Co. v. *Public Service Commission*, 262 U. S. 679.

Vandalia Railroad Co. v. *Schnull*, 255 U. S. 113.
Union Tank Line Co. v. *Wright*, 249 U. S. 275.
Brooks-Scanlon Co. v. *Railroad Commission*, 251 U. S. 396.
Northern Pacific Ry. Co. v. *North Dakota*, 236 U. S. 585.
Public Serv. Ry. v. *Board*, 96 N. J. L. 54.
Scott v. *Eagle Fire Co.*, 7 Paige 198.
Hope Mutual Life Ins. Co. v. *Perkins*, 4 Rob. 182.
Kenton Ins. Co. v. *Covington*, 86 Ky. 213.
Cook on Corporations, Sec. 546.
6 Fletcher Ency. of Corp. p. 6104.

The Missouri statute (Sec. 6222 R. S. Mo. 1919) requires the setting aside of an unearned premium reserve as a liability to care for future losses, expenses and return premiums on outstanding policy contracts. The state may not require the setting aside and maintenance of such a reserve and refuse to allow the income necessary to provide it.

Public Service Railway Co. v. *Board of Public Utility Commissioners*, 96 N. J. L. 54, 114 Atl. 323.

Losses and expenses incurred, for which liability exists, during the test period may not be rejected merely because they are not paid.

The earned and incurred method is in universal use in the insurance business, has the express approval of National Convention of Insurance Commissioners, and is adopted into the Federal statutes by Congress in the levy of income tax upon insurance companies (Sec. 246 of the Revenue Acts 1921, 1924 and 1926); and is prescribed by the annual statement blanks of the forty-eight states as the basis for reporting underwriting experience.

The Missouri statutes prohibit payment of dividends out of unearned premium (Sec. 6333 R. S. Mo. 1919). It is un-

reasonable and confiscatory to treat unearned premiums as accrued income, when they are not free assets and cannot be distributed as dividends.

II.

The application of $2,301,132 interest earnings from investments to a reduction of rates for underwriting is unreasonable and confiscatory.

The majority opinion treats all premiums received, both earned and unearned, as income—thereby treating unearned premiums as the unqualified property of petitioners. Notwithstanding this, the majority opinion also includes as underwriting income $2,301,132 interest earning derived from the investment of unearned premiums. These two propositions are fundamentally inconsistent.

Dissenting opinion herein (R. 3044-6).

Insurance companies have two separate activities, underwriting and investment, each being productive of a profit or a loss. The majority opinion takes investment income and applies it to a reduction of operating or underwriting rates. The effect of this is to compel petitioners to do their underwriting business at a loss if by the application of income from invested assets such loss may be overcome. Inadequate rates for underwriting, standing alone, cannot be justified upon the ground that petitioners are earning income from their invested assets (over which the state concededly has no control in the making of rates) sufficient to overcome the loss in underwriting. Petitioners are entitled to rates sufficient to make their underwriting activity, standing alone, reasonably profitable. Anything less than this is a denial of due process.

Smyth v. *Ames*, 169 U. S. 466 l.c. 540.

Board of Pub. Utility Comm'rs v. *New York Tel. Co.*, 271 U. S. 23.

C. M. & St. P. R. R. Co. v. *Pub. Util. Comm.*, 47 S. Ct. Rep. 604.

Interstate Comm. v. *U. P. R. R. Co.*, 222 U. S. 541, l.c. 549.

Brooks Scanlan Lbr. Co. v. *R. R. Comm.*, 251 U. S. 396.

No. Pac. Ry. Co. v. *No. Dakota*, 236 U. S. 585, l.c. 599.

Vandalia R. R. Co. v. *Schnull*, 255 U. S. 113.

Norf. & W. Ry. Co. v. *West Virginia*, 236 U. S. 605.

Minnesota Rate Cases, 230 U. S. 352.

Chas. V. Duffy v. *Mut. Benefit, etc. Ins. Co.*, 272 U. S. 613.

III.

The deduction from petitioners' expenses of $2,496,715 excess commissions paid to their St. Louis agents is unreasonable and confiscatory.

These commissions were a reasonable and necessary expense, forced upon petitioners by competition and by the higher cost of operating agencies in St. Louis, and by the additional service furnished by St. Louis agents.

This expense was incurred in good faith and without any abuse of discretion. The incurring of it was a matter requiring business judgment. The State of Missouri is not empowered to substitute its judgment for the honest discretion of petitioners; and cannot, consistently with the due process clause, order a rate reduction based upon an arbitrary exclusion of this expense.

Southwestern Bell Tel. Co. v. *Pub. Serv. Comm.*, 262 U. S. 276 l.c. 288.

Houston v. *Southwestern Telephone Co.*, 259 U. S. 318, l.c. 323.

Ohio Utilities Co. v. *Pub. U. Comm.*, 267 U. S. 359, l.c. 363.

Banton v. *Belt Line Ry.*, 268 U. S. 413, l.c. 421.
Dayton Goose Creek Ry. v. *U. S.*, 263 U. S. 456, l.c. 483.
Wolff Packing Co. v. *Court*, 262 U. S. 522.
Int. Comm. Comm. v. *C. G. W. Ry. Co.*, 209 U. S. 108, l.c. 118.
L. & N. R. R. Co. v. *U. S.*, 238 U. S. 1.
State ex rel. v. *Conn*, 156 N. E. Rep. (Ohio) 114.
N. W. Nat'l. Ins. Co. v. *Fishback*, 130 Wash. 490; 228 Pac. 516.
Welsh v. *Maryland Ins. Co.*, 47 Okla. 933.

IV.

The rejection of $628,123 war tax as an item of expense is unreasonable and confiscatory.

This tax was actually paid as a necessary incident to doing business in Missouri (Sec. 504-5, Revenue Act of 1917, Sec. 503-b, Revenue Act of 1918), and was a proper item to be included as outgo. Its rejection was unreasonable and confiscatory, and in direct conflict with the decisions of this court.

Galveston Electric Co. v. *Galveston*, 258 U. S. 388, l.c. 399.
Georgia Railway & Power Co. v. *Railroad Commission*, 262 U. S. 625, l.c. 633.
Pac. G. & E. Co. v. *San Francisco*, 265 U. S. 403, l.c. 406.
C. & N. W. Ry. Co. v. *Dey*, 35 Fed. Rep. 866, l.c. 881.

V.

The opinion below in fixing 8 per cent of premiums received, or $6,680,169, as a reasonable profit upon the business of the test period, is confiscatory, because it fails to make allowance for proper elements of income and outgo, and for reserves; the fact being that petitioners were compelled during the test period to set aside reserves in the average amount of $12,717,006, 60 per cent of which was drawn from premiums received.

Northern Pac. Ry. Co. v. *Dept. of Pub. Wks.* 268 U. S. 39.

Ohio Utilities Co. v. *Pub. U. Comm.*, 267 U. S. 359.

Int. Com. Comm. v. *U. P. Ry.*, 222 U. S. 541, l.c. 547.

Bluefield Water Works & Imp. Co. v. *Public Serv. Comm.*, 262 U. S. 679.

Vandalia R. R. Co. v. *Schnull*, 255 U. S. 113.

Union Tank Line Co. v. *Wright*, 249 U. S. 275.

Brooks Scanlon Co. v. *R. R. Comm.*, 251 U. S. 396.

N. P. Ry. Co. v. *No. Dak.*, 236 U. S. 585.

C. M. & St. P. Ry. Co. v. *Pub. Ut. Comm.*, 47 S. Ct. Rep. 604 l.c. 606.

Southern Ry. Co. v. *Commonwealth*, 47 Sup. Ct. Rep. 542.

VI.

The Rating Act (Sec. 6283, R. S. Mo. 1919) as now construed and applied by the Supreme Court of Missouri in the instant case, is unconstitutional, for each of the reasons assigned herein.

The statute as written was not attacked by petitioners, but the statute as construed and applied in the instant case was attacked, as depriving petitioners of their property without due process of law, thereby presenting a federal question.

Myles Salt Co. v. *Iberia Drainage District*, 239 U. S. 478, l.c. 484.

Reagan v. *Farmers Loan & Trust Co.*, 154 U. S. 362, l.c. 390-391.

Greene v. *Louisville & Interurban Railroad Co.*, 244 U. S. 499, l.c. 507.

Raymond v. *Chicago Traction Co.*, 207 U. S. 20.

Castillo v. *McConnico*, 168 U. S. 674.

Old Colony Trust Co. v. *Omaha*, 230 U. S. 100.

The statute as construed and applied is unconstitutional upon each of the grounds asserted by petitioners in their attack upon the reduction order.

See points and authorities cited, I to V, *supra*.

VII.

If any single point of attack made by petitioners upon the rate reduction order is sustained, the order must fall.

The opinion sustains the order by the narrow margin of $607,040. That is, the opinion finds that with the reduction applied, petitioners would during the five-year period have derived a profit only $607,040 in excess of a reasonable profit. Each point of attack upon the order involves more than $607,040. Therefore, if any one or more of petitioners' contentions are sustained, the rate reduction is demonstrably confiscatory.

VIII.

While this court will accept the construction adopted by the Missouri Supreme Court in arriving at the meaning of the rating statute, nevertheless if the statute as construed and applied deprives petitioners of property without due process of law, this court will reverse the judgment.

Hanover Fire Ins. Co. v. *Harding (Carr)*, 272 U. S. 494.

Standard Oil Co. v. *Graves*, 249 U. S. 389, l.c. 394.

Crew Levick Co. v. *Pa.*, 245 U. S. 292, l.c. 294.

St. Louis-Southwestern Ry. Co. v. *Arkansas*, 235 U. S. 350, l.c. 362.
Galveston Ry. Co. v. *Texas*, 210 U. S. 217, l.c. 227.
Kansas City Ry. Co. v. *Kansas*, 240 U. S., l.c. 231.
Frost v. *Railroad Commission*, 271 U. S. 583.
Dahnke-Walker Milling Co. v. *Bondurant*, 257 U. S. 282, l.c. 290.

IX.

The decision below does not rest upon independent non-federal grounds. The federal rights asserted were of such character that no judgment adverse to petitioners could be rendered without denying them; and they were necessarily denied by the result of the opinion and judgment below.

C. B. & Q. R. R. Co. v. *Chicago*, 166 U. S. 226, l.c. 231-2.
C. B. & Q. R. R. Co. v. *Drainage Commr's*, 200 U. S. 561 l.c. 580.
West Chicago Railroad v. *Chicago*, 201 U. S. 506, l.c. 519.
Schlemmer v. *Buffalo, Rochester & P. Ry. Co.*, 205 U. S. 1, l.c. 11.
Chicago Life Ins. Co. v. *Needles*, 113 U. S. 574, l.c. 579.
International Harvester Co. v. *Missouri*, 234 U. S. 199.
Green Bay Canal Co. v. *Patten Paper Co.*, 172 U. S. 58, l.c. 66-68.
McCullough v. *Virginia*, 172 U. S. 102, l.c. 116-117.
Kaukauna Co. v. *Green Bay & Canal Co.*, 142 U. S. 254, l.c. 269.
Eureka Lake & Y. Can. Co. v. *Yuba Co.*, 116 U. S. 410.
Toledo, Etc., R .R. Co. v. *Slavin*, 236 U. S. 454.
Carondelet Canal Co. v. *Louisiana*, 233 U. S. 362.
Otis Co. v. *Ludlow Mfg. Co.*, 201 U. S. 140.
Fiske v. *Kansas*, 47 Sup. Ct. Rep. 655, l.c. 656.

X.

The questions involved herein are not questions of fact but of law which this court has jurisdiction to review.

Bluefield Water Works & Improvement Co. v. *Public Service Commission*, 262 U. S. 679.

State of Missouri ex rel. Southwest Bell Telephone Co. v. *Public Service Commission*, 262 U. S. 276.

Northern Pacific Ry. Co. v. *Department of Public Works*, 268 U. S. 39, l.c. 44.

Ohio Utilities Co. v. *Public Utilities Comm.*, 267 U. S. 359.

Vandalia Railroad Co. v. *Schnull*, 255 U. S. 113.

Northern Pacific Railway Co. v. *North Dakota*, 236 U. S. 585.

Norfolk & Western Railway Co. v. *Conley*, 236 U. S. 605.

C. M. & St. P. Ry. Co. v. *Pub. Ut. Comm.*, 47 Sup. Ct. Rep. 604, l.c. 606.

Norfolk & Western Ry. Co. v. *West Virginia*, 236 U. S. 605, l.c. 609-610.

Creswill v. *Knights of Pythias*, 225 U. S. 246, l.c. 261.

Oregon Railroad and Navigation Co. v. *Fairchild*, 224 U. S. 510, l.c. 528.

Southern Pacific Co. v. *Schuyler*, 227 U. S. 601, l.c. 611.

Wood v. *Chesborough*, 228 U. S. 672, l.c. 678.

Acme Harvester Co. v. *Beekman Lbr. Co.*, 222 U. S. 300, l.c. 305-6.

XI.

The petitioners have property and property rights in Missouri entitled to protection under the constitution.

Terral v. *Burke Constr. Co.*, 257 U. S. 529.
Fid. & Dep. Co. v. *Tafoya*, 270 U. S. 426.
Carroll v. *Greenwich Ins. Co.*, 199 U. S. 401, l.c. 409.
Hanover Fire Ins. Co. v. *Harding* (*Carr*), 272 U. S. 494, l.c. 508.
Des Moines Gas Co. v. *Des Moines*, 238 U. S. 153, l.c. 165.

The petitioners' agency plants and established business are actually worth $4,265,302, and constitute property within the protection of the Fourteenth Amendment.

Hanover Fire Ins. Co. v. *Harding* (*Carr*), 272 U. S. 494, 508.

Good will alone is property.

Crutwell v. *Lye*, 17 Vesey, 335 (opinion by Lord Eldon).
Washburn v. *Nat. Wall Paper Co.*, 81 Fed. 17.
See v. *Heppenheimer*, 61 Atl. (N. W.) 843.
Rowell v. *Rowell*, 99 N. W. (Wis.) 478.
Godley v. *Crandall*, 139 N. Y. Sup. 236.
Clabaugh v. *Heibner*, 236 S. W. 396.
Bettendorf v. *Bettendorf*, 190 Iowa 83.
Lindeman v. *Rusk*, 125 Wis. 210.
Langer v. *Fargo Merc. Co.*, 186 N. W. 104.

The going value of an established business is a valuable property right.

Des Moines Gas Co. v. *Des Moines*, 238 U. S. 153, l.c. 165.
Denver v. *Denver Water Co.*, 246 U. S. 178, l.c. 192.
McCardle v. *Indianapolis Water Co.*, 272 U. S. 400.
Dorchy v. *State of Kansas*, 272 U. S. 306.
Truax v. *Corrigan*, 257 U. S. 312, l.c. 328.

ARGUMENT.

I.

The rate reduction order of the Superintendent of Insurance was based upon a calculation of petitioners' profit or loss for the test period upon the basis of premiums received less losses and expenses paid, instead of upon the basis of premiums earned less losses and expenses incurred. The basis so adopted is fundamentally erroneous, unreasonable and confiscatory.

(A) The Missouri Statute.

The Missouri statute provides for rate revision when:

> "it appears that the result of the earnings in this state of the stock fire insurance companies, for five years next preceding such investigation, shows that there has been an aggregate profit therein in excess of what is reasonable."

It further provides that in such case the superintendent may:

> "order such reduction of rates as shall be necessary to limit the aggregate collections by insurance companies in this state to not more than a reasonable profit."

There are features of the statute determining its scope clearly defined by its terms which are in no way affected by the construction of the state court.

In ascertaining the experience, the test period is fixed at *five years* next preceding. This precludes taking a longer or a shorter period, or any period of five years, except that next preceding. There is no room for construction in this particu-

lar, nor is any construction of the statute on this phase undertaken by the Supreme Court of Missouri. The limit of the inquiry of the Superintendent preliminary to invocation of power is a determination, not of what *might* have resulted under different circumstances, or what *could* have been derived under hypothetical situations; but what he is to consider is "the result of *earnings* * * * *for five years.*"

The territorial scope to be included in his inquiry is provided to be "the earnings *in this state.*"

He is not to ascertain the profits of this, that, or the other company, but "the stock fire insurance companies' * * * *aggregate profit.*" If an aggregate profit in excess of what is reasonable is not shown the Superintendent is given no power to make any order.

It is not provided how this profit shall be computed. The only standard in this particular is that his power shall arise only when such aggregate profit is "in excess of what is *reasonable.*"

In the event that his powers arise under past experience then in making a reduction order, he is not given discretion to make a reduction which may or may not leave a reasonable profit; but he may order such reduction "as shall be *necessary* to limit the aggregate collections * * * to not more than a reasonable profit."

(B) The business of insurance.

The business of insurance is highly complex, the making of equitable rates in which is involved in scientific estimations of probability, many, if not most, of which are determined in laboratories where, by test and experiment, the fire resistive qualities of objects are ascertained with great nicety, and rates predicated upon elements involving structure, exposure, protection, combustibility and damageability. The affixing of rates upon inflammable oils and pig

iron, to determine the relatively proper charges, presents problems of the greatest nicety. These considerations involve, also, the distribution of equitable charges between different communities, so that the charges may be equitably distributed as between the different communities in a state. A proper perspective contemplates also an equitable distribution between states, involving considerations of the different structures in the various states, the differing insurable properties there existing and their qualities, as in case of cotton in one state and grain in another; the difference in climatic conditions, taking into account the aridity of one and the heavy rainfall or snowfall in another. The balance of all these elements one against the other is what permits equitable charges, so that a merchant in one state may have assurance that the burden of the insurance his industry bears shall not be disproportionate to the insurance burden of his competitor —perhaps in a remote state.

It is true, that each state must consider the experience within the limits of the state itself in applying the police power which it exercises as sovereign. It cannot, however, adopt a standard violative of universal reasonable practice of the insurance business without injury to other contributors to the common guarantee fund, continued existence of which assures the ability of the company to meet its obligations, wherever they may be. In a business in which scientific standards are accepted and common in the business and universally recognized in it, they cannot be ignored by the state and arbitrary standards set up in their place which result in confiscation, without violating constitutional rights.

The establishment of reserves to make provision for carrying out of contracts extending into the future and for losses which have happened is universal in the business of insurance and expressly commanded by the statute of Missouri. The Superintendent or other rate-making authority of the state may not, we contend, overthrow such universal usage and

statutory recognition without bearing the stigma of arbitrary and unconstitutional invasion of private right. The police power is simply the power of government. Its exercise is subject to constitutional limitations.

The history of regulation of fire insurance, in a general way, may be stated as follows:

Fire insurance, according to its modern conception, had its birth in the great London fire of 1666. Premium charges were fixed at two shillings per cent for insuring brick buildings, and double that amount for insuring brick and timber buildings. Insurance on property other than buildings was not then undertaken.

Further classifications were applied in 1721, when the method was adopted of dividing risks into three classes:

1. Common,
2. Hazardous,
3. Doubly hazardous,

the business remaining virtually unregulated by law and with little progress in scientific rating methods until 1890. The New York fire of 1835, caused insolvency of more than twenty insuring companies.

In the same year (1835) Massachusetts, consequent upon this conflagration, enacted a law requiring establishment of reserves. Such statute was enacted in New York four years later. Prior to that great fire, such reserves had been set up by some companies and not by others, and the practice was almost universally adopted after that object lesson. The statute only declared what was the practice of the surviving companies, regardless of statutes.

The Chicago fire occurred in 1871, and the Boston conflagration in 1872. Forty-two companies became insolvent as a consequence of these fires. As a result of that experience, not only were reserves set up for the indemnity provided by un-

expired policies, but the policy became universal to set up surpluses to meet major shocks.

The great adjustment difficulties arising out of difference in policy forms caused a general revision of policies to a common standard following this fire. This was followed in the ensuing year by enactment of a standard policy law in Massachusetts.

Following the fires mentioned, a great disorganization in the business occurred, followed by cut-throat competition, in which every company proceeded regardless of its competitors. Rates were, in general, flat, with no attempt of analysis of hazards, and whatever cooperative spirit had existed among insurance companies theretofore was destroyed, the National Board of Fire Underwriters was dissolved, and the general policy pursued of every company for itself. Following this trend of the companies, the legislatures of the various states enacted stringent anti-compact laws, enforcing individual action by companies and prohibiting their cooperation in rate-making.

In the meantime, great progress was made in formation of scientific schedule for analyzing hazards, and in 1892 the Universal Mercantile Schedule and in 1903 A. F. Dean's Analytic Schedules were published, placing rate-making on a scientific basis whereby the hazards in one risk might be measured against the hazards in other property. This development of knowledge resulted in cooperation of companies and the enactment of statutes in various states, commonly known as Anti-discrimination Acts, requiring the companies to treat their policyholders with equality, so that one should pay no more for insurance than his neighbor. Such legislation was reasonable only because of the establishment of scientific methods of measurement making standards of equality possible. Such statutes, to the extent they are operative, depart from the theory of anti-compact laws prohibiting common action, and in states taking such action—such as Missouri—

common action of the companies in rate-making is encouraged, if not commanded.

A common standard exists in the business and is universally employed therein and, without exception, employed by all companies in their own profit calculations—namely, by excluding unearned premiums from income and by including in outgo incurred but unpaid losses and expenses. The adoption of a common standard is an essential to reasonableness in rate charges.

If a different standard of reason were permissible in each state at the mere will of the state, without any consideration of the usages of the business, the method of its conduct, the natural laws to which the business is bound to conform, the exigencies which it cannot escape, and its conduct in fact, it would not only be chaotic but it would be an abandonment of the standard of reason. We respectfully submit that reason applied in Missouri in reaching a standard of measurement cannot lead to a result different than applying reason in Massachusetts or New York. A common standard is not only desirable but it is necessary if broad averages country-wide are to be taken into account, because there can be no method of determining those averages if a different standard be adopted in every hamlet through the country.

Insurance policies are usually written for terms of one, three or five years (R. 251, 206), the average term of all such policies at the time of the trial being two years and seven months. By universal usage in the business, the premium is payable at the beginning of the term—in other words, when the policy is written (R. 206).

Immediately upon the writing of a policy of insurance, the laws of Missouri require the setting aside of a reserve, denominated the "unearned premium reserve." The portion of the premiums stipulated in the policies which must be so reserved by the terms of the statute is "50 per cent of the

gross premiums on all unexpired fire risks that have less than one year to run, and a pro rata of all gross premiums on risks that have more than one year to run (Sec. 6222, R. S. Mo. 1919; printed in appendix hereto).

The effect of this statute is to require the reserving of a pro rata of the gross premium upon all policies.

The reports made to the State are all made as of December 31st of each year, and as the policies written during the course of the year from day to day are, upon the average, written upon July 1st of the year (namely, half before that date and half after that date), therefore all annual policies in force at December 31st have, on the average, run for 50 per cent of their term.

The purpose of setting up an unearned premium reserve under such statute is to remove from the free funds of the company, which it may expend in dividends or otherwise at will, the sum representative of premiums which insure for the future and, therefore, should be set aside to provide for future losses and expenses. This fund is to take care of future losses and expenses and the return of unearned premiums in case of cancellation of policies, which contain provisions for their cancellation at the option of either the insurance company or the assured at any time. (R. 843, 889-90, 211, 359, 362-3, 697-8, 732, 803, 804-5, 1533, 1630, 1955, 2120.)

In the case of a single policy, the elapsing of time from day to day after the policy is written causes an additional amount daily to become earned, and therefore that much less daily to be unearned, until at the expiration of the policy (or upon payment of a total loss) it all becomes earned. (R. 704, 706, 209-10, 230, 477-8.)

There is no provision in the Missouri statute that a reasonable profit shall be any particular percentage or amount. The consequence of the failure of the statute to define a rea-

sonable profit therefore, requires that resort to be had to usages, experience and methods of insurance companies.

The practice and method of insurance companies in computing profit and loss is universally that of taking earned premiums (rejecting receipts properly reserved for discharge of obligations for the future) as income, and incurred losses and expenses (whether paid or unpaid) as outgo, the difference indicating the profit or loss.

(C) The method of calculation adopted by the court below.

The Superintendent of Insurance of Missouri in making the rate order in question, and the Supreme Court of Missouri in confirming the validity of that order, both based their calculation of profits upon the aggregate premiums *received* during the five year test period, less losses and expenses *paid* during that period, and rejected the basis of premiums *earned* as income, less losses and expenses *incurred* as probative of profit or loss. Petitioners insist that the methods so adopted are fundamentally erroneous and unreasonable. A reduction of rates based upon such method is confiscatory and deprives the petitioners of their property without due process of law.

The method adopted by the Superintendent and confirmed in the decision of the Supreme Court of Missouri, was to treat as accrued income all premiums *received* during the five year test period, $83,502,181, altho the amount of premiums derived by the petitioners, paying for insurance for such term—(or otherwise stated, the earned premium)—was only $74,813,860. In short, $8,688,365 of premium receipts derived during the test period were treated as income, altho it is undisputed that such sum was unearned and paid for insurance subsequent to December 31, 1921 (which was the last day of the test period), and subject to contingency of return upon cancellations. Such balance which was not earned during the test period was taken as accrued income

of the test period in reaching a balance designed to show profit. (See Plaintiff's Exhibits 1359 and 1361 at R. 1925 and 1934; and see findings of the majority opinion of the Supreme Court of Missouri at R. 3007, 3034-5.) The method so adopted treated as accrued income of the test period the premium receipts, whether earned or unearned and whether paying for insurance within or beyond the test term. It is conceded and undisputed in the record that such sum of $8,688,365 of premium receipts was not earned during the test period, but at December 31, 1921 was a part of the unearned premium reserve to pay for insurance indemnity to be furnished from December 31, 1921 forward. The Supreme Court of Missouri, by means of these calculations included, as income, amounts which were not "earnings," and treated as profit sums which were not "aggregate profits" of the petitioners for the five-year test period. Whether they would or would not become earnings, or would or would not produce profits in some other term or some other period is not a matter of inquiry. The Supreme Court of Missouri does not reject the five-year test period, but purports to adopt it. Its method of calculation, however, is unsound. As five-year policies written in December, 1921, would not expire by their terms until December, 1926, taking into account the premiums which paid for indemnity during such years to the year 1926 could not possibly disclose the earnings which were had in a period ending December 31, 1921.

The basis adopted by the Supreme Court of Missouri in sustaining the rate order ignores the fact that such portion of the premiums upon policies unexpired at December 31, 1921 which pay for insurance in the future are subject to two distinct contingencies:

(*a*) Repayment to policyholders upon cancellation, as provided in the policies;

(*b*) Payment of losses and expenses under such policies.

Since insurance policies are written for one, three and five year terms, the premiums received thereon during a five year test period extend in some instances for three to five years beyond the end of the test period. On the other hand, expenses are paid almost immediately after they are incurred, and losses are paid within sixty days after incurred. Therefore, a calculation of profit upon the basis of premiums received less losses and expenses paid, is productive of the following result, which demonstrates its fundamental error:

The received and paid basis takes into account:

Premiums received which pay for indemnity during	Losses and expenses ~~paid~~ during years
years	1916
1917	1917
1918	1918
1919	1919
1920	1920
1921	1921
1922	
1923	
1924	
1925	
1926	

Upon the basis above, losses occurring in 1916 under policies expiring in 1916 would be taken into account but no part of the income from the same policies is considered. Also premiums paying for insurance for years 1922 to 1926 are taken into account as income but none of the losses for those years considered.

Thereby the method takes into account the losses and expenses of one period and the premiums of a different period.

The appended graph discloses the periods for which the insurance provided in one-year, three-year and five-year pol-

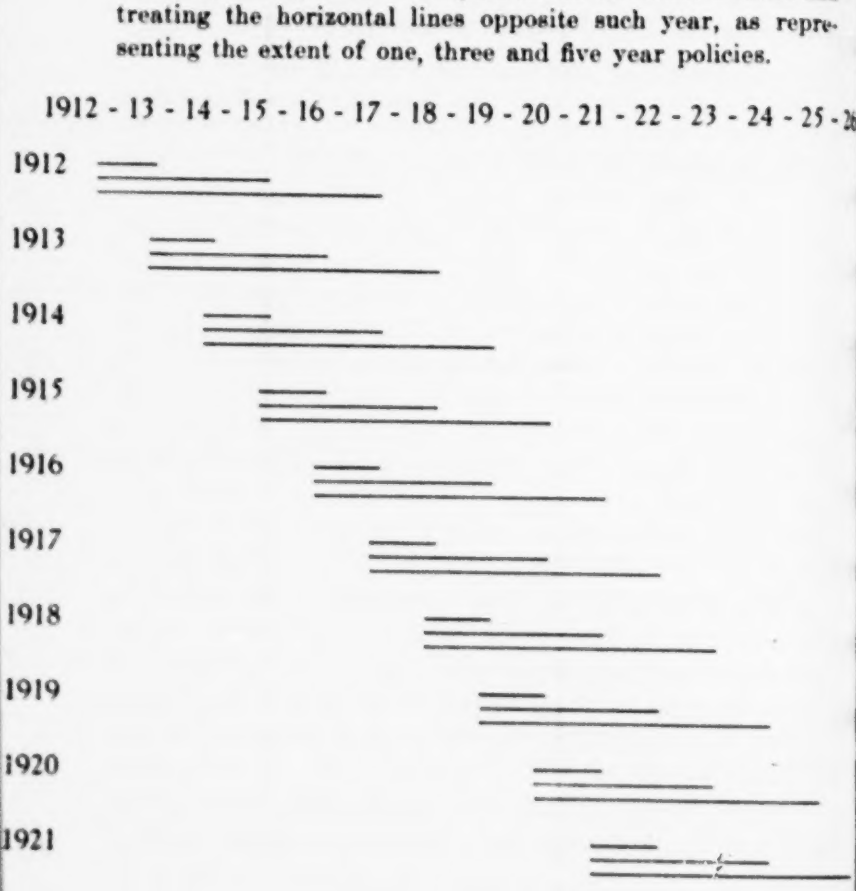
icies extends. Thus the three horizontal lines appearing opposite the year 1912 extend as follows:

One-year policies into the year 1913,

Three-year policies into the year 1915,

Five-year policies into the year 1917.

The year in which the policies were written is to be ascertained by taking the desired year in the left-hand column and treating the horizontal lines opposite such year, as representing the extent of one, three and five year policies.



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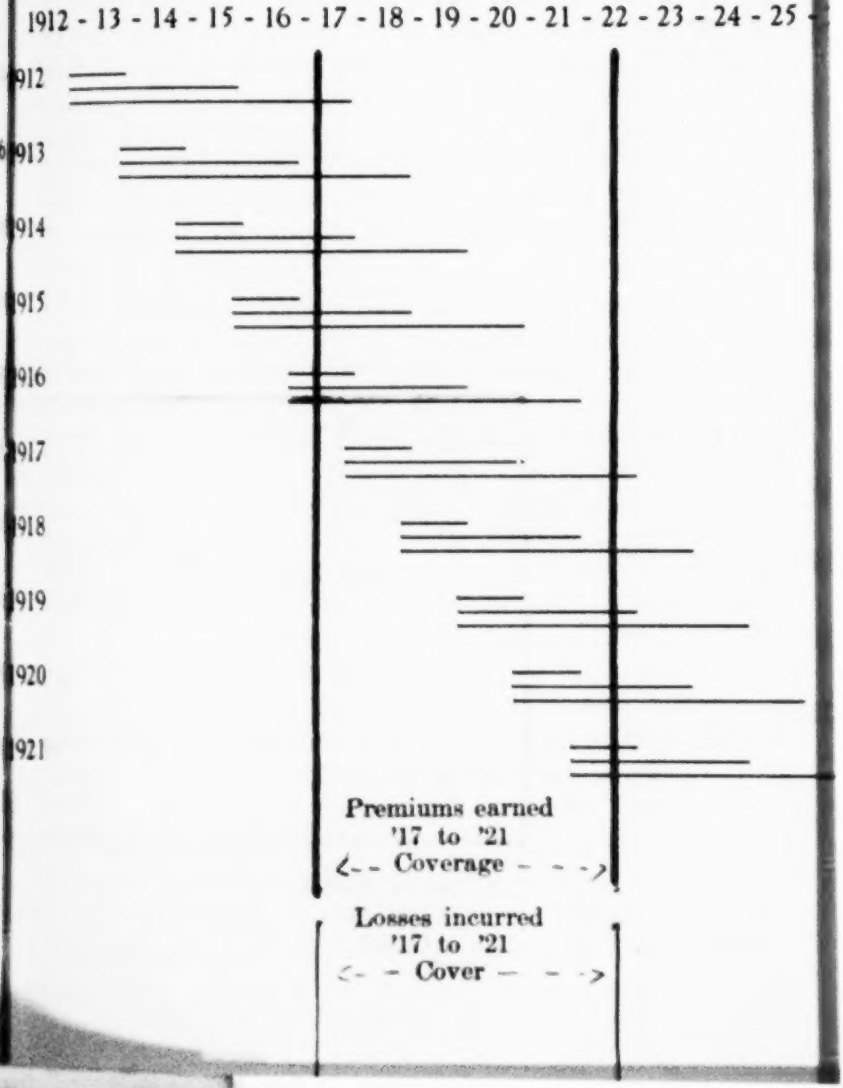
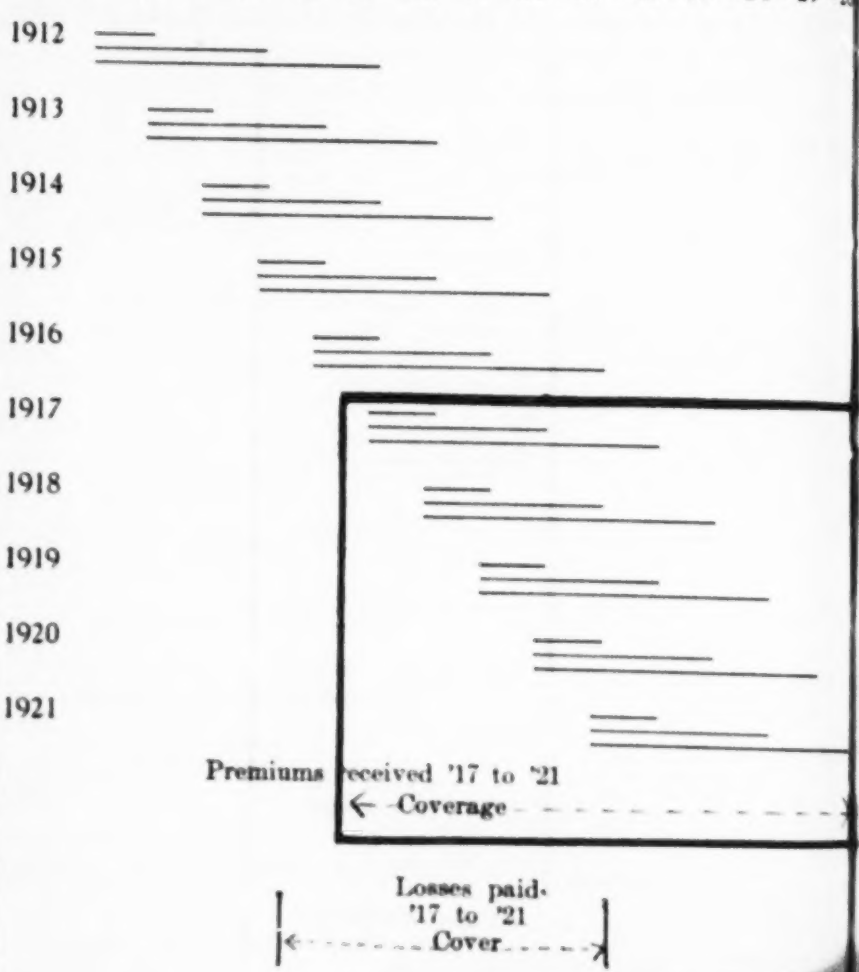
The earned premiums for the years 1917 to 1921 will be found segregated in the next graph wherein the earned premiums are contained within the limits of the heavy vertical lines. The incurred losses for the years 1917 to 1921 are the losses for the years shown between the heavy lines beneath.



The result of taking the written premiums for the years 1917 to 1921 are shown by the following graph and beneath we have set out the period of time covered by paid losses, paid during the same period.



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As long as any part of the premium received remains unearned (the service and indemnity paid for not having been rendered), such prepaid amount is subject to being absorbed in whole or in part by repayment upon cancellation or by payment of losses and expenses, and it cannot logically be treated as accrued income. Until it is earned, the premium remains subject to such future contingencies, and by law it is set up as a liability to meet them. (Sec. 6222 R. S. Mo. 1919.) Unearned premium, whether made up out of premiums or out of surplus is not a free fund in the sense in which free surplus is unfettered. The free surplus may be distributed as dividends or otherwise diverted to the benefit of stockholders, but the sum which is reserved by the statute is subject to restrictions, so that it is not profit and may never be.

To illustrate: Suppose an insurance company during a given year receives $100,000 in premiums paid in advance for insuring $10,000,000 of specified property for five years of time, and that during the first year it pays out $90,000 in losses and expenses, leaving a balance of cash on hand of $10,000, (which balance is sometimes referred to in the record as a "trade balance") (R. 3019). The decision of the Supreme Court of Missouri is to the effect that such $10,000 trade balance would be clear profit. It disregards the fact that such company would still have nearly ten million dollars of insurance in force to run four years longer and that the reserve statutes of the state require $80,000 more or less as a reserve to care for such future liabilities. To denominate the balance of $10,000 as a profit, leaving nothing whatever to care for future losses, expenses and return premiums upon existing contracts is fallacious in the extreme.

When premiums are collected in cash, the proceeds, whether retained in form of cash or invested in securities or otherwise disposed of, constitute assets. For the portion of such premium receipts, for which value has not been delivered,

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although contracted for, an offsetting liability exists. It is in principle the same as if a merchant bought goods which, upon their receipt, became subject to be counted in his inventory as an asset. If such goods, however, were not paid for, then, to the extent for which liability existed, an offsetting liability item in such case designated "accounts payable" must be set up to show a true balance when a profit and loss balance is sought to be made. The insurance company is paid in advance for indemnity over a period of years. If, at any given date, it is sought to find the profits or losses to that date, then, to the extent that moneys have been so paid for which indemnity and service has not been furnished, the obligation to furnish it still remains.

The word "profit" means gain. If a mercantile business is done for a year on a cash basis, and goods are sold and delivered during the year for cash and all expenses are paid in cash, and if its inventory is the same at the beginning and end of the year, then obviously the way to ascertain the profit is to deduct the cost and expense from the income received. This is the received and paid method, and it is proper enough in the case of a business where the income and outgo are all on a cash basis. But the insurance business is not that kind of a business (R. 231-2). The insurance company collects its premium in advance, but in turn issues a contract to indemnify against loss, which may occur at any time during a period of months or years. The transaction is not closed until the termination of the policy, either by its expiration or cancellation or by payment of a total loss (R. 704, 706, 209-10, 230, 477-8). In other words, the company has not earned the whole premium, and cannot earn it, until liability on the policy has ceased.

This principle is not confined to the insurance business alone. The same principle is applicable to any mercantile or other business in which obligations incurred in a given year are partially performed in that year, leaving the re-

mainder to be performed in the following year; in arriving at the profit for the given year the earned basis necessarily has to be used.

Consider by way of illustration a newspaper which takes subscriptions for 100,000 papers at one dollar per year, and receives $100,000 on July 1st for a year's subscription ending the next July. Up to December 31st, a period of six months, it has cost the newspaper company $50,000 to furnish these papers. If the company then figured up on a cash basis to determine its profit for the six months, it would (under the received and paid basis) cast up its income at $100,000 and its cost at $50,000 and call the balance of $50,000 a profit. Yet this would obviously be wrong because it would overlook the fact that the newspaper company was obliged to furnish papers for six months more to subscribers who had prepaid their subscriptions. Obviously, such company could not determine its true profit until it would set aside a reserve that would pay the expense it would have to incur in fulfilling its obligation, for which its subscribers had paid in advance. The newspaper company could not truthfully say on December 31st that it had made a profit of $50,000, for it would be faced with the obligation to pay out money for six months more, into the new year, in order to fulfill its existing contracts with subscribers.

Just so in the case of an insurance company. A company that has received in advance $100,000 during the year for three years' insurance, and has paid out in losses and expenses during the year, $50,000, and at the end of the year finds itself obligated to carry the risk of loss for two and a half years, or to return the unearned portion of the premium at the request of the insured, cannot properly say that its profit during the year has been $50,000, for the simple reason that it is not true. If it undertook to reinsure the business the next day, it would cost it over $60,000 in cash.

We do not know of any class of business men, who are honest with themselves, who would think for a moment of ascertaining their profits by crediting themselves with their entire receipts without making an appropriate deduction for liabilities.

It is a fact of common knowledge that in every well organized business, the item of prepaid insurance premiums is treated as an asset of the policyholder. An honestly run business cannot keep its accounts in any other way, if it is to reflect the truth in fact. We take it that the law ought to be in reasonable harmony with the honest practices of the business world. Certainly a practice that is uniformly followed should not be discredited and the exact opposite said to be the law. Prepaid (i. e., unearned) insurance premiums cannot very well be, at one and the same time, an asset of the policyholders and a "profit" of the insurance companies.

While the unearned premiums do not constitute an indebtedness still, because of the obligation of the companies for which these premiums are to compensate, the Missouri statute expressly denominates the unearned premium reserve as a liability (Section 6222 R. S. Mo. 1919), and in the same view the annual statement, filed by insurance companies, in every state of the United States, inclusive of Missouri, sets up their unearned premium reserves as a liability (R. 951, 1277).

Witnesses, testifying on the subject, without exception stated its nature from a bookkeeping standpoint to be that of a liability. (R. 847, 889-90, 960, 971-2, 698, 705, 767, 510, 801, 810, 1064-5, 1159, 1161, 1192, 1498-9, 1533-4, 1955, 2775.)

The earned and incurred method of calculating underwriting profits has for years been embodied in the income tax laws enacted by Congress. (See Sec. 246 of Revenue Acts of November 23, 1921, June 2, 1924 and February 26, 1926, printed in appendix hereto; and see R. 864, 876.) By these enactments the statutes, since 1921 through their various

amendments, have constantly retained the definition of underwriting income as follows:

> "The term 'underwriting income' means the earned premiums on insurance contracts during the taxable year less losses incurred and expenses incurred."

As the sole purpose of the tax so imposed was to impose a tax upon profits or earnings of insurance companies, it is persuasive of the correctness of the method so expressly adopted by Congress.

The earned premium and incurred loss method has been approved in two reported cases, which will be noted more fully hereinafter.

Such method was approved by the Supreme Court of Arkansas in

Bullion v. *Aetna Insurance Co.*, 151 Ark. 519,

(a rate case) and, in a profits tax case, was approved by the House of Lords in England in

Sun Insurance Office v. *Clark*, App. Cas. Law Rep. 1912, p. 443.

Not only is the basis of earned premiums and incurred losses and expenses sound, according to the practice and usage of underwriters (R. 767), and inescapably compelled by the requirement of the Missouri statutes requiring the maintenance of unearned premium reserve (Sec. 6222 R. S. Mo. 1919), and the prohibition of such statutes against paying dividends out of unearned premiums (Sec. 6333 R. S. Mo. 1919). But if no such statutes or usage existed, the practice would have to be created by economic necessity. Entirely independent of statutes, unearned premium has repeatedly been held properly excluded from profit balances. The propriety of so excluding it from income in arriving at profit has been repeatedly declared, entirely regardless of statute.

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In *Scott* v. *Eagle Fire Co.*, 7 Paige 198, (N. Y.) the court said:

> "The unearned premiums received by the company on the risks that are still running, and which may therefore all be wanted to pay losses which may happen on those risks, are not surplus profits which the directors are authorized by the charter to distribute among the stockholders."

This language was used independently of any statutory provision.

In *Hope Mutual Life Ins. Co.* v. *Perkins*, 4 Rob. (N. Y.) 182, the court said:

> "Unearned premiums cannot be said to be profits."

The Supreme Court of Kentucky in *Kenton Ins. Co.* v. *Covington*, 86 Ky. 220, say:

> "These unearned premiums are retained under the law by the corporation to provide against contingent losses. It is a fund set apart for that purpose, and in the usual course of business in like corporations, such a reserve fund would usually be retained, even if no statute existed requiring it."
>
> *Cook on Corporations*, Sec. 546;
>
> *6 Fletcher Ency. of Corporations*, p. 6104.

The decision of the Supreme Court of Missouri treats $8,688,365 of unearned premiums as "earnings" or "profit." A corporate "profit" which the corporation cannot use for payment of dividends, distribution to stockholders, or for any other purpose without making the corporation insolvent, is, to say the least, a unique kind of profit.

To treat the entire premium rates as accrued income, without any deduction of reserve to meet future liability presently contracted for, is necessarily productive of a false statement, if it is designed to disclose operating profit or loss. If any of the petitioners should make a distribution of their assets so as to impair this reserve and distribute any

portion of its unearned premiums to stockholders, upon such failure to maintain such reserve the company would, under the statutes of Missouri, be insolvent, and its license would be forfeited. (R. 2119, 2284, 2795-6.)

When a premium for *one year* is exacted, it is to meet outgo and provide profits for *one year*. If the same property is insured in like amount for *five years*, the greater premium is exacted to meet fire losses, pay expenses and provide profits during *five years*.

As this court say, in the case of *Pennsylvania Mutual Life Ins. Co.* v. *Lederer*, 252 U. S. 523, l. c. 531, there speaking of the protection afforded by fraternal beneficiary societies:

> "There the premiums paid by the member were supposed to be sufficient, and only sufficient, to pay the losses which will fall during the current year, just as premiums on fire, marine or casualty insurance are supposed to cover only the losses of the year or other term for which the insurance is written."

This shows a recognition of the earned premium basis, in that the basis upon which the premium is fixed is upon estimation of the pro rata of the amount required on all policies to furnish indemnity with a profit *over a period of time*. If such indemnity is received on a theory that it will be for insurance for five years, then to assign it all to the year in which it is written instead of the term for which it is written will produce a fictitious amount five times that which the company had in estimation when it wrote the insurance. In other words: The received and paid basis produces a fictitious charge which is entirely variant from the charge intended and exacted when the policy was written.

The same sound and simple methods of honest accountancy which require the use of the earned premium method likewise necessitate the adoption of a basis of incurred losses and expenses for arriving at a profit and loss balance, and require the rejection of a basis of paid losses and expenses.

If the profit or loss for a test period is to be ascertained, there are two essentials, ignoring of which will produce a false balance:

1. If the experience for a given five-year period is to be ascertained, the losses and expenses in fact applicable to that period must be ascertained. It cannot possibly be proper with two companies deriving exactly the same amount of premiums and suffering exactly the same losses and expenses to say that one company makes no profit and its competitor makes a very large profit, owing to the sole fact that the former paid its losses during the test period and the latter, while suffering identical losses, for some reason has not yet paid them.

2. It is obviously improper to measure all losses and expenses for one term of years against income, consisting of premiums for a different term of years. Likewise, it is necessarily productive of a false profit and loss statement to take income from some policies, and losses and expenses on other policies, and measure them one against the other. The Referee summed up the propriety of the incurred loss and expense basis aptly in his report (R. 2918) where he said:

> "Common honesty demands that one who has incurred an obligation should make provision for its payment. * * * One may not contract a debt and count it a profit: If a man erects a building at a cost of $50,000, and in doing so pays $25,000 for labor and material, and then sells it for $50,000, leaving incurred but unpaid bills in the sum of $25,000, can he be said to have made a profit of $25,000 or any other profit? The question answers itself. He cannot. Incurred obligations, if just, must be paid and there can be no profits until they are paid. It follows that the incurred basis is correct."

Assume, for illustration, that the San Francisco conflagration had occurred in the latter part of December, 1906. The losses occasioned thereby would not, in that event, have been paid within that year. The application of the received and

paid basis to the business of insurance companies at the close of that year might, in that event, have shown a profit upon their California business when, in fact, they incurred a $350,000,000 loss (R. 981.) In fact, the loss was so great that many companies were rendered insolvent by that conflagration (R. 917).

The significance of the point here under discussion under this record lies in the fact that the losses and expenses paid during the five-year test period were $80,161,057. The losses and expenses incurred were $81,824,016. (R. 3007, 3034-5; see, also, petitioners' exhibits 1359 and 1361 at p. 1925 and 1934.) The adoption of a proper method of computation—that of the incurred basis—therefore, is productive of an outgo figure of $1,662,959 greater for the test period than the paid losses and expenses during the same period. The liability of the petitioners for all such losses and expenses incurred was firmly fixed and established during the test period (R. 1036-8, 1386, 1507).

The evidence in the record is overwhelming from witnesses who have spent their lives in the insurance business, that from their experience the underwriting profit of insurance companies cannot be correctly ascertained except by ascertaining the difference between earned premiums as income and incurred losses and expenses as outgo. (R. 831-3, 837, 959, 209, 181-2, 216-7, 227-8, 666-7, 698-9, 711, 420-1, 1173-4, 1206, 1310, 1486, 1505-6, 1536-7, 1604, 1667, 1687, 1782-3, 1787.) Not only is such method universal in the business, but its abandonment leads to a fundamentally wrong basis, because the written and paid basis ignores reserve requirements. (R. 209, 195-6, 708-9, 764, 766, 806, 182, 959, 960, 1506, 1660.)

The witnesses testifying for the defendant upon the subject were compelled to admit that by adoption of the received and paid basis the whole premium received is treated as earned during the test period, notwithstanding the terms of the policies may extend far beyond such period. They are

forced to the position that the unearned premium liability is ignored as if nonexistent. (R. 2790, 2778.) The defendant's witnesses further admitted that by application of the received and paid method a profit might be shown; yet when the required reserves were taken into account, the company might be insolvent in fact and ineligible to do business in Missouri. (R. 2798, 2142, 2284-5, 2795-6, 837-8, 864-5.)

It is respectfully submitted that a method of calculation which leads to consequences so absurd that a company making a report of its supposed profits upon the basis contended for by our opponents would be shown to be making a handsome profit when, in fact, it was insolvent and must be barred from doing business in the state by the Superintendent, is a method so unreasonable and arbitrary that no more is necessitated for its rejection than an understanding of its effect if applied in practice.

As is pointed out in the dissenting opinion of the Missouri court, it has, for many years, been "the universal custom and practice of stock fire insurance companies to compute their underwriting profits on the basis of earned premiums" (R. 3045.) This statement in the dissenting opinion is completely supported by the record. The record shows without dispute that the earned and incurred method of profit calculation is in universal use by all insurance companies in their profit calculations, not only for rate-making purposes but for all the purposes of information within such companies themselves. Such method has been in universal use in the business for more than forty years. (R. 959, 1538, 228, 233, 863, 1310, 1359, 1369-70, 1459, 1504, 1660, 754, 1426, 1428, 1516, 1532-3, 1538.) In fact, no other method of profit calculation has been considered or employed in the business within the memory of those engaged in it. (R. 228, 233, 872.)

The various states of the United States have respectively an insurance officer, who supervises the business of insurance within his state. He is designated either "Insurance

Superintendent" or "Insurance Commissioner," as the case may be. These State officers are all members of a voluntary association, which convenes annually. It is called the "National Convention of Insurance Commissioners." This organization has existed for many years past, and these commissioners meet and exchange views respecting regulation, control, and supervision by the State of the business of insurance. That body appointed a committee of its own members, who made investigation for two years respecting the adoption of a standard for profit measurement, to which they could give their approval in the interest of uniform and just methods of ascertainment of profit for regulatory purposes. At a meeting of their convention, held in New York on December 7, 1921, that body adopted the report of its fire insurance committee, which had made a two-year investigation of the subject we have mentioned. The report of the committee, so approved by the convention, provided among other things as follows:

> "Underwriting profit (or loss) is arrived at by taking from earned premiums all incurred losses and incurred expenses." (R. 831, 1371.)

Great weight should be given to the action of this convention, for its membership consisted entirely of representatives of the insuring public, namely, state officials, whose primary duty it is to protect the insuring public in their states in their dealings with insurance companies. The adoption by such a body of officials, after two years of investigation, of a method of measurement admitted by them to be just, is a fact of the highest importance as tending to establish the correctness of such a basis. Their familiarity with the subject matter and the entire absence of any reason on their part for adopting a standard unfair to the State makes their conclusions of almost controlling importance.

Insurance companies are prohibited by law from paying dividends out of unearned premiums (See 6333 R. S. Mo.

1919). If unearned premiums cannot legally be used for the payment of dividends, then with what possible reason may it be urged that they may be treated as "earnings" or "profit" in making the calculation called for by the Missouri Rating Act? An insurance company would be violating the law if it should distribute its unearned premiums in dividends. Notwithstanding this, the opinion below treats $8,688,365 of unearned premiums as "earnings" or "profit." It is respectfully submitted that a "profit" which legally cannot be distributed in dividends is most unique, and of a genus not hitherto judicially defined.

The earned and incurred method is employed in the annual statement blanks in each of the forty-eight states of the union, including Missouri. This blank is commonly known as the "convention form," because it was adopted by the National Convention of Insurance Commissioners. It is a fact of striking significance that in the annual statements to the forty-eight states the insurance companies are required to show their national underwriting profit or loss upon the earned and incurred basis (R. 187-190, 863, 228, 232, 709, 1371, 1536-7, 2141-2, 2204, 2295, 2806-7.) The same form of blanks is in use in all the states (R. 181, 709, 863, 2142, 2806-7, 2850-1), and has been for many years (R. 2133, 2291-2.) It passes the bounds of belief that the earned and incurred basis can be wrong, and yet that every state in the Union would employ it for the purpose of ascertaining underwriting profit.

The Missouri court seeks to avoid the effect of these considerations by the argument that the report called for by the annual statement blank is a mere solvency test. We submit that this is no answer at all. If the earned and incurred method is proper for ascertainment of solvency, as the Superintendent's witnesses expressly admit it is (R. 2142, 2874), it is necessarily the proper method to determine whether a profit has been made. The Supreme Court of Ar-

kansas in *Bullion* v. *Aetna Ins. Co.*, 151 Ark. 519, 237 S. W. l. c. 718, said:

> "The Commissioner says, however, that it is not the purpose of the reports made pursuant to this statute, to enable or to require him to pass upon the amount of profits earned by the reporting companies, but only to determine their solvency. So it is. But if this is the proper method to determine solvency, it is necessarily the proper method to determine whether profits have been made."

If in testing the solvency of the companies, the Insurance Department should determine by the earned and incurred method that the companies have lost money, certainly the department ought not in reason to be permitted, by using a different method, to conclude that the companies made money, and upon that finding still further to reduce rates. To permit the state to do this might be to permit it to find the companies insolvent on the earned and incurred basis, yet further to reduce rates by the use of the received and paid basis. This is palpably unreasonable. For if a company, or all the companies, should appear to be insolvent by the application of one method (the earned and incurred), the State of Missouri under its insurance laws would have to forbid them from writing business within its borders; yet at the same time by the use of the received and paid method the State might still further reduce rates. *Reductio ad absurdum.*

By the very language of the Rating Act itself (Sec. 6283 R. S. Mo. 1919) the ultimate fact to be found is, what was the amount of "earnings" in this state of the stock fire insurance companies for the five year test period? Can it be said with any show of reason that a portion of the premium which the statute requires to be set up as a reserve, and which the statute forbids the companies to pay out in dividends, is an "earning"? The Superintendent seeks to charge the petitioners not alone with that portion of the premiums which

they have earned, but also with that portion of the premiums which they have not earned during the test period, and will not earn until subsequent years, and which may in part never become earned, but may have to be returned to policyholders on cancellation. The conceded fact is that in common practice twenty per cent to twenty-five per cent of all premiums received are ultimately returned to policyholders on cancellation (R. 972-3, 733, 1360-1, 1580.)

A given written premium income during an elapsed five-year period if consisting in larger part of three-year and five-year policies (losses upon which would occur during three and five years to come) if duplicated in exactly the same volume of premiums during the next five years but during which the preponderance of business was one-year business (losses upon which would occur during only one-year to come) would produce violently differing results in the two test terms. Evidence of the volume of written premium income, therefore, creates no presumption that the same volume of premium would produce a like profit balance.

Proof of an identical premium volume disregarding the term of the contracts is creative of no presumption whatever that the rates for the future will be compensatory. So also, if the paid loss basis be adopted, if, in the test period, large losses occur which are not paid by its final date, and during the succeeding five years such losses are paid, and newly occurring losses identical in amount are also paid during that period, then with two periods identical in their loss experience in fact, one is, by the Missouri method, loaded with losses which do not belong to it and the other freed of losses for which it has engaged to pay. Thus no presumption may be drawn that the losses paid during the past will be duplicated in the future even if the *fire loss experience* be identical. Upon such paid basis if a number of companies became insolvent and can not pay their losses during a given period selected for test, then the elimination from profit calcula-

tion of such unpaid losses would be productive of an aggregate seeming profit greater than if they were solvent and paid their debts.

If *all* the companies became insolvent, during a test period, and none could pay their losses or expenses, then their premium income previously derived would prove to be 100 per cent profit. The greater the number of companies defaulting in their contracts and the greater the number who became insolvent, the greater would be the "profit" and the more warrantable would a rate reduction be. A conflagration of such magnitude as to destroy a dozen companies would be a blessing to the public, because the premiums having been *paid* and losses and expenses incurred *not* having been paid, the business upon consideration of its aggregate experience would show a better experience than if the companies had been able to pay their debts. The greater the destructive major conflagrations which should occur, the lower would rates be if Missouri is right in its conclusions.

The basis of the rate order being a fundamentally unsound and confiscatory one, its adoption makes the rate order void.

This court has definitely spoken respecting a similar arbitrary basis in the case of *Northern Pacific Railway Co.* v. *Department of Public Works*, 268 U. S. 39, l. c. 44-45, wherein this court say:

> "In this unit cost figure no account is taken of the difference in unit cost dependent, among other things, upon differences in the length of haul, in the character of the commodity, in the configuration of the country, in the density of the traffic, in the daily loaded car movement, in the nature of the equipment employed, in the extent to which the equipment is used, and in the expenditures required for its maintenance. Main line and branch line freight, interstate and intrastate, carload and less than carload, are counted alike. *The department's error was fundamental in its nature.* The use of this factor in computing *the operating costs of the log traffic vitiated the whole process of reasoning by which the department reached its conclusion.*

> The mere admission by an administrative tribunal of matter which under the rules of evidence applicable to judicial proceedings would be deemed incompetent (*United States* v. *Abilene & Southern Ry. Co.*, 265 U. S. 274, 288, 44 S. Ct. 565, 68 L. Ed. 1016), or mere error in reasoning upon evidence introduced, does not invalidate an order. ***But where rates found by a regulatory body to be compensatory are attacked as being confiscatory, courts may inquire into the method by which its conclusion was reached.*** An order based upon a finding made without evidence (The *Chicago Junction Case*, 264 U. S. 258, 263, 44 S. Ct. 317, 68 L. Ed. 667), or upon a finding made upon evidence which clearly does not support it (*Interstate Commerce Commission* v. *Union Pacific R. R. Co.*, 222 U. S. 541, 547, 32 S. Ct. 108, 56 L. Ed. 308), is an arbitrary act against which courts afford relief. *The error under discussion was of this character. It was a denial of due process.* Compare *New York & Queens Gas Co.* v. *McCall*, 245 U. S. 345, 348, 38 S. Ct. 122, 62 L. Ed. 337." (Italics are ours.)

In the case of

Public Service Ry. Co. v. *Board of Public Utility Commissioners*, 96 N. J. L. 54 (114 Atl. Rep. 323),

the Supreme Court of New Jersey had for review an order suspending an increased street car rate. The controlling act provided that when a public utility increases its rates "it shall be the duty of the said board to approve any such increase, change, or alteration upon being satisfied that the same is just and reasonable." The Public Utility Act delegated to the commissioners the power to require public utilities to furnish safe, adequate, and proper service and to carry an adequate depreciation account. The carrying of such an account had been required of the Public Service Railway Company (called in the opinion the prosecutor), by the commissioners, and the court held that the carrying of such an account thus became an element necessary to be considered in fixing a just and reasonable rate for the services rendered.

The court said:

> "To make an order requiring a public utility to set apart yearly a depreciation fund of a fixed amount and to prevent a compliance by refusing the income necessary for that purpose is not the fixing of a just and reasonable rate."

In *Chicago, Milwaukee & St. Paul Railway Co.* v. *Public Utilities Commission of Idaho*, 47 Sup. Ct. Rep. 604, l. c. 606, the railway petitioned this court for certiorari to review a judgment of the Supreme Court of Idaho, affirming an order of the Public Utilities Commission of that state reducing rates for transportation of saw logs. This court reversed the judgment on the ground, among others, that the State Commission had used a fundamentally erroneous method of computation. This court followed the principle announced in *Northern Pacific Railroad Co.* v. *Department of Public Works*, *supra*, and held:

> "It is clear that the methods by which respondent reached its conclusion were arbitrary and constituted a denial of due process of law."

And in *Southern Railway Co.* v. *Commonwealth*, 47 Sup. Ct. Rep. 542 (a tax case), this court said:

> "But, if the method pursued in valuing property within the state is arbitrary and the resulting valuation is grossly excessive, the tax must be condemned as in contravention of the due process clause of the Fourteenth Amendment. *Union Tank Line Co.* v. *Wright*, 249 U. S. 275, and cases cited."

Other decisions of this court applying substantially the same principle are as follows:

Ohio Utilities Co. v. *Public Utilities Com.*, 267 U. S. 359.

Vandalia R. R. Co. v. *Schnull*, 255 U. S. 113.

Brooks-Scanlon Co. v. *R. R. Com.*, 251 U. S. 396.

Northern Pacific Ry. Co. v. *North Dakota*, 236 U. S. 585.

Union Tank Line Co. v. *Wright*, 249 U. S. 275.

Southern Ry. Co. v. *Commonwealth*, 47 Sup. Ct. Rep. 542.

Ohio Utilities Company v. *Public Utilities Commission*, 267 U. S. 359.

Interstate Commerce Commission v. *Union Pacific Railroad Co.*, 222 U. S. 541, l. c. 547.

Bluefield Water Works and Improvement Co. v. *Public Service Commission*, 262 U. S. 679.

Union Tank Line Co. v. *Wright*, 249 U. S. 275.

Interstate Com. Comm. v. *U. P. R. R.*, 222 U. S. 541, l. c. 547.

The calculation for determination of operating profit upon the received and paid basis is fundamentally erroneous and unreasonable, and the reduction of rates predicated upon such method is confiscatory and a denial of due process.

The paramount importance of this point is self-evident. By the use of the received and paid method the amount of petitioners' income for the test period is erroneously increased by $8,688,365, and the amount of their outgo is erroneously decreased $1,682,959,—making a difference in the aggregate of $10,351,324 in the final tabulation of profit or loss.

The earned and incurred method has met with the explicit approval of the English House of Lords and of the Supreme Court of Arkansas in two learned opinions dealing with this subject-matter.

In the case of *Sun Insurance Office* v. *Clark*, App. Cas. Law Rep. 1912, p. 443, the House of Lords had for consideration the profits of an insurance company proper to be considered under the income tax act of Great Britain. The question presented was whether, in the determination of profit, it was allowable to make "a proper reserve for unexpired and unearned premiums, to throw the real premium income into

each year to answer its actual losses." The earned premium basis was sustained by the court, several opinions being filed. (Sir Rufus Isaacs appeared for the crown.)

In the opinion of Lord Chancellor Earl Loreburn, it is said (l. c. 450):

> "When a fire insurance company is to be assessed for income tax the main point to be ascertained will be what has been the gain or the loss upon the contracts of insurance which it has effected in each of the three years which are taken to make the average. If it were practicable, the accurate way, I suppose, would be to add together the premiums which the company became *entitled* to receive in each year, say, 1903, upon contracts made in that year, and then to add up the losses which the company became bound to pay upon those contracts made in the year 1903. The difference between these two sum totals would show precisely what was the gain of the company or their loss in respect of the contracts made in the year 1903. But this is impracticable because contracts of fire insurance are made all through the year from January 1 to December 31; and most of them, or at all events many of them, are made to cover fire risks for a year, some we are told for five or six or seven years, from the date of their making. The premium is paid in advance. So the result in the way of gain or loss could not be ascertained as a fact until after the period of time had elapsed. Now, the tax collector cannot be asked under the income tax acts to wait until the end of that period. Thus it appears that you cannot base the assessment of income tax upon the actual facts of the business done, and the actual pecuniary results of it, in the case of fire insurance companies who take single premiums to cover risks for a year or for more years. This is such a company and I believe nearly all companies are in the same position. If that be so it follows that in assessing such fire insurance companies you must proceed wholly or in part by estimate."

The court after reviewing first the method of making a computation policy by policy, and ascertaining the earned and unearned portion of it, says it must be rejected because impracticable and "such a process as to the unexpired contracts would be minute and almost interminable (p. 452).

The court then proceeds to the second method (the written and paid basis for which the Superintendent is contending in the case at bar) and says:

> "The second method suggested in that case (a case cited) was that of merely taking for each year the sum total of the premiums received and the sum total of the losses paid, and subtracting the one from the other without regard to the fact that the premiums cover risks running on into subsequent years and the losses include losses arising out of contracts made in previous years. This method is, of course, not precise or scientific" (p. 452).

Further discussing the so-called written basis the court says:

> "I can conceive it being unfair either in the case of a rapidly increasing or of a rapidly diminishing fire insurance business. It may prove unfair in other cases.
> • • •
> *No one in this House has said that it ought to supersede the truth if the truth is in conflict with any case.*"

In referring to the written and paid basis, he further said:

> "A rule of thumb may be very desirable, but cannot be substituted for the only rule of law that I know of, namely, *that the true gains are to be ascertained as nearly as it can be done.*"

Lord Loreburn then proceeds to a discussion of the third method, namely, the earned and incurred method, and says:

> "A third method similar in principle to that advanced by the now appellants was also considered by Your Lordships in the case of McGowan. This method is to carry forward annually at the close of the year a percentage of the premium income in order to allow for unexpired risks. It has no pretentions of being precise. I can easily imagine cases in which an actuary could show it was misleading. *But if it comes nearer to the truth than any other method in a particular case I do not understand why it should not be adopted.*" (p. 452.)

In the concluding portion of the opinion of Earl Loreburn he says, after reciting the evidence:

> "In these circumstances it seems to me quite obvious that the third and not the second method must be applied here for the plain reason that upon the materials before us *it is the fair and only way presented to us by which the truth can be approximately attained.*" (p. 453.)

In the concurring opinion of Viscount Haldane, who later succeeded Lord Loreburn as Lord High Chancellor of England, he said:

> "It is plain that the question of what is or is not profit or gain must be primarily one of fact, and of fact to be ascertained by the tests applied in ordinary business. Questions of law can only arise when (as was not the case here) some express statutory direction applies and excludes ordinary commercial practice, or where, by reason of its being impracticable to ascertain the facts sufficiently some presumption has to be involved to fill the gap.
>
> Such a presumption was made in the appeal referred to, where, as pointed out in the judgment delivered by the Lord Chancellor, it was not shown that the percentage deducted represented the real value of the risks yet to run, and was so unearned, and where it appeared further that the company had actually divided the entire amount without reduction among its shareholders as part of the profit of the year. In *Gen. Acc. Fire & Life Asso. Corp.* v. *McGowan*, it was therefore in the absence of evidence to the contrary presumed that the whole of the premium income received in the year represented income earned by bearing the risks of the year. It is difficult to see how on materials before the House the decision could have been otherwise, but it seems to me to be equally clear that the reason of the decision has no application here, as here *it has been accurately ascertained that part of the premiums are not in the nature of profit earned. As Bray, J., puts it, the case is analagous to one in which if goods are bought their value cannot be treated as profit without deducting the value of the liability to pay for them which the buyer has incurred.*"

Lord Alverstone rendered a concurring opinion and, among other things, said:

> "It is not disputed that, as a matter of principle, the claim of the appellants is well founded. *Premiums are not profits or gains, they are receipts which must be brought into account, and out of which, after proper deduction for losses, profits will accrue.*"

The opinion of Lord Alverstone concludes with the following language:

> "The only matter in dispute was the right of the appellants in estimating the profits or gains to make a reduction in respect of the outstanding premiums due to increased business during the three years under consideration."

In another opinion in the case by Lord Atkinson (all of the opinions determine the questions in favor of the earned premium method) he says:

> "That case (*Gresham* v. *Styles*, Appeal Cases, 1892, 309) clearly decided that the receipts of a business are not in themselves profits and gains within the meaning of the Income Tax Act, but that it is what remains of those receipts, after there has been deducted from them the cost of earning them, which constitutes the taxable profits and gains. Now what is the service which a fire insurance company renders to each insured in consideration for the premium it receives? It is only by rendering this service in each case it earns these receipts. The service consists in indemnifying the insured against loss by fire during the continuance of his policy. The company is entitled to deduct what it will cost it to perform that service. In any given case where a fire occurs, the loss, and therefore the cost of the service by which the premium is earned, may and almost certainly will vastly exceed the premium, but in the aggregate of all the policies the aggregate cost will, of course, be much less than the aggregate premiums. The difficulty of the position consists in this, that until the time for which a policy is to remain effective has expired, nobody can tell precisely how much the service will cost. Yet, until that time has expired the service for which the company has

been paid has not been completely performed. *If the accounts of the company are to be rendered before the date of expiry then some division of the premium must be made, and the portion to be appropriated to the service already rendered ascertained, the balance being appropriated to that portion of the service which is to be performed thereafter. I think the description 'unearned premium' which has been used to describe this latter portion is a very appropriate and accurate description.*" (pp. 460-461.)

The opinion of Lord Atkinson further proceeds:

"Having regard therefore to the fact that companies carrying on this kind of business are under the decision of Your Lordships' House clearly entitled to object to their receipts being treated as *per se* their profits and gains without the proper deduction having been made of the cost of earning those receipts, it is obvious that the amount of the taxable profits and gains can only be ascertained by some system of averages or estimation or by some other practical rule of thumb based upon experience and the facts of different cases." (p. 462.)

The concluding language of his opinion is as follows:

"*In this particular case it is shown upon the evidence that the method contended for by the appellants is in this instance at all events a better method, juster, and more satisfactory in its application and results than that insisted upon by the Crown.* It should therefore, I think be approved of and applied in preference to the latter." p. 464.) (Italics are ours.)

The question as to proper method of calculating underwriting profit was presented in the case of *Bullion* v. *Aetna Insurance Co.*, 151 Ark. 519, 237 S. W. 717. Arkansas has a statute providing as follows:

"If it appears that for such five year period the stock fire insurance companies doing business in this state have made an aggregate underwriting profit in excess of five per cent, the Insurance Commissioner shall have the power to order such reduction in rates as will reduce the underwriting profit on business thereafter done to five per cent."

The Arkansas Insurance Commissioner made an order reducing insurance rates, and the companies brought suit to review the order. The case turned upon the question as to the proper method of calculating underwriting profit or loss, whether the received and paid method or the earned and incurred method. The Insurance Commissioner had used the received and paid method. Upon the review proceeding the chancery court found in favor of the earned and incurred method, and set aside the reduction order. Upon appeal the Arkansas Supreme Court likewise upheld the earned and incurred method. In the course of the majority opinion it was said, 237 S. W. l. c. 718:

> "We think the undisputed evidence shows that the term 'underwriting profit' has long had a definite, certain and well-known meaning in insurance circles. A number of witnesses of highest authority in the insurance business testified that the term was understood alike by all insurance men, and that the word 'underwriting' refers to operations of the companies in accepting and carrying risks on the writing of insurance, and refers to that branch of the insurance business in contradistinction from the investment or banking end of the business, and *that underwriting profit or loss is arrived at by deducting from earned premiums, all incurred losses and incurred expenses.* These experts testified that this definition and use of the phrase 'underwriting profits' was of universal application in all insurance business, and that a different meaning was first given to it by the Insurance Commissioner of this state in his attempt to give effect to the Act now under consideration.
>
> Prior to the passage of this Act of 1919, the Insurance Commissioner of this state was required to calculate the reinsurance reserve for unexpired fire risks of insurance companies by taking 50 per centum of the premiums received on all unexpired risks that have less than one year to run and a pro rata of all premiums received on risks that have more than one year to run and, 'having charged against a company the reinsurance reserve as above determined, * * * and adding thereto all other debts and claims against the company, he shall, in case he finds the capital stock of the company impaired to the

extent of twenty per centum, give notice to the company to make good its whole capital stock within sixty days, and, if this is not done, he shall require the company to cease to do new business within this state. * * *' Subdivision 6, Sec. 5951, C. & M. Digest.

The Insurance Commissioner testified that the term 'reinsurance reserve,' in the statute quoted, meant 'unearned premium reserve,' and that the latter is the commonly used term.

It is quite obvious that this legislation treated the unearned portion of an insurance premium as a liability against the company, and not as an asset of the company. *It cannot, therefore, be regarded as a profit, for the reason that the law requires the insurance companies to maintain a reserve against it.* This Section 5951, C. & M. Digest, was enacted in 1875, and requires the Commission to charge all 'debts and claims' against the company, which necessarily includes all losses and expenses which have been incurred, whether they have been paid or not.

We think this statute defines the status of the unearned premium reserve. If it is in fact a liability, and not an asset, then it cannot properly be the basis of computing profits. *It is not a profit, for the simple reason that it is not earned. It may never be earned. The company could not use it for paying dividends or for other purposes of its own.* Cook on Corporations (7th Ed.), Sec. 546, Vol. 2, p. 1609. On the contrary, it must maintain a legal reserve against it, and if, adding to this reinsurance reserve 'all other debts and claims against the company,' there is an impairment to the extent of 20 per cent, the Commissioner must declare the company not sufficiently solvent to do new business in this state.

The Commissioner says, however, that it is not the purpose of the reports made pursuant to this statute to enable or to require him to pass upon the amount of profits earned by the reporting companies, but only to determine their solvency. So it is. *But if this is the proper method to determine solvency, it is necessarily the proper method to determine whether profits have been made.* At least, this was the existing law when the Act of 1919 was passed, and we must construe the two statutes together.

It is shown without question that the premium earned basis is the method employed by all insurance companies in determining what profits have been earned and whether a dividend can be paid the stockholders.

Numerous very interesting cases are cited in the briefs of counsel for the insurance companies to the effect that unearned premiums cannot be said to be profits.

The objection of the Commissioner to the adoption of the premium earned basis, that he could not make a finding upon that basis from the reports of the companies on file in his office, is equally applicable to the basis which he did adopt, for he admits that it became necessary for him to prepare and send out to the companies special blank forms, which he designated as Schedule No. 6, before he could prepare his report in accordance with the basis which he had decided to adopt. It is also shown that, in support of the companies' motion for a rehearing before the Commissioner, the companies offered to, and did, supply all the information necessary to make a report on the premium earned basis; but the Commissioner refused to change his ruling, for the sole reason that he thought he had adopted the proper method. At the time Schedule No. 6 was prepared by the Commissioner for the purpose of making the finding required by Section 8 of the Act of 1919, a schedule numbered 5 was also prepared, the responses to which would have furnished the necessary data for making a finding in accordance with the premium earned basis, and that schedule was prepared to fit in to page 8 of the Convention Annual Blank, of which blank we shall have more to say.

This Convention Annual Blank takes its name from the fact that it was prepared and adopted by the Convention of Insurance Commissioners of the different states, and is in universal use and has been for many years past. Page 8 of this Convention Blank calls for a tabulation made on the incurred or premium earned basis of the business of the companies all over the United States, while Schedule 5, prepared on similar basis, restricts the report to the business done to this state alone, and the tabulation made on that basis by the Commissioner shows that there was no underwriting profit for the five year period under review.

This difference is said to result from the fact that during the latter part of the five year period the volume of

insurance business in this state increased very largely and very rapidly. Much of this business then written, and already paid for, will have to be carried as outstanding risks by the various companies beyond the five year period under review. Under these circumstances there has been no underwriting profit if the same is computed according to the premium earned basis.

Any question as to the manner of securing the necessary data to report on either basis may be disposed of by saying that the law gives the Commissioner the right to call for such data as he sees proper to have, and imposes upon the companies the duty to furnish it. Sections 5960 and 5965, C. & M. Digest."

The court then sets forth the facts relating to the adoption of the earned and incurred method in the report of the Insurance Commissioners Convention of December 7, 1921, and the court proceeds in its opinion as follows (l. c. 720):

"This report is, of course advisory in its nature, and binding upon no one, but it does show what these officers understood underwriting profit or loss to mean.

It does not appear that the Commissioner of Arkansas attended this convention, although Arkansas is the state referred to in the report as having a fixed percentage of insurance rates. This report appears to have been adopted by the unanimous vote of all the Commissioners present.

It thus appears that 'underwriting profit' or loss has a known meaning as the sum arrived at by deducting from earned premiums all incurred losses and incurred expenses, and that the term, as thus interpreted, has long been employed in the insurance business, and we must, therefore, conclude that it was so used in the Act of 1919, nothing to indicate a contrary intention appearing in the Act.

Having reached this conclusion, we should not be swerved from so interpreting it by any consideration of the results obtained. It may be said, however, in passing, that the fear expressed by the Commissioner that, if he adopted the premium earned basis, losses would be pyramided, that is, credit would be given more than once for the same losses, appears to be without founda-

tion. It is very clearly shown that this could not be done without deliberately falsifying reports, and a false report could, of course, be made on either basis. It is shown that the 'Convention Form of Annual Statement' automatically takes care of this by requiring deductions to be made of profits and credits taken, and in the same way any errors of estimation are taken care of by deductions in the next period.

The court below made the following findings:

'The words "underwriting profit" have had for a long number of years, and now have, a well-known, established and defined trade meaning, to-wit, net premiums earned less losses and expenses incurred in the business of writing fire insurance, and that those words were used in that sense in the Act under consideration in this case.'

Upon this finding the court ordered that, in making up his tabulations, the Insurance Commissioner should use, in said calculations, the aggregate net premiums earned during the five year period, as distinguished from the net premiums received, and that he should use losses incurred during said period, as distinguished from losses paid, and should use expenses incurred as distinguished from expenses paid.

It follows, from what we have just said, that this finding and order of the court is correct, and it is approved."

The opinion of the court was written by Justice Smith. Justice Wood in the course of his concurring opinion said (l. c. 722):

"Mr. Leigh's testimony and that of every other insurance rate expert shows that in insurance circles and according to insurance terminology the words 'underwriting profit' have one and only one definite and well understood meaning; that meaning is arrived at by one and only one definite method of calculation. That meaning is:

'What the companies have left over from the premiums earned after deducting the losses and expenses incurred' during the period designated.

All of the witnesses give the same definition in practically the same language. To quote from one is to quote from all. Frank M. Speakman, who was employed

by the appellant in the examination of different insurance companies from time to time as consulting actuary and who was not in the employ of, or connected with, any insurance company, testified:

'I am familiar with the Arkansas Act of 1919 under consideration and know that the phrase "underwriting profit" used in the act has had for a number of years among accountants and the insurance fraternity a well-established and well-defined meaning. It has only meant one thing, and that is the profit left over after the company has been charged with premiums earned and taken credit for losses and expenses incurred.'

The record shows that the committee of the National Convention of Insurance Commissioners, composed of commissioners of eleven states, and the Actuarial Bureau committee of the National Board of Fire Underwriters, recommended the same method of ascertaining underwriting profits as is shown by the testimony of the insurance rate experts above. The appellant alone dissented from the views of these committees.

Since the Legislature used the trade term 'underwriting profit' and nowhere in the act used any language indicating that it had employed this term in any other than a technical sense and with the meaning given it by those engaged in the insurance business, it must be conclusively presumed that the Legislature intended that the words 'underwriting profit' should have the meaning given them in insurance circles. To ascertain what that meaning is, the testimony of insurance rate experts and the recommendation of the committees of the National Convention of Insurance Commissioners and of the National Board of Fire Underwriters were all competent evidence to prove the meaning of the term 'underwriting profit.' See *National Union Fire Ins. Co.* v. *Dickinson*, 128 Ark. 367, 194 S. W. 254. If not the undisputed, at least the overwhelming weight of the evidence shows that the meaning of the term is as above set forth in the testimony of Leigh and Speakman. Unless we shut our eyes to the facts and refuse to respond to the preponderance of the evidence, and fail to apply the law applicable thereto, the only correct conclusion on this branch of the case is that reached by us and voiced through the opinion of Mr. Justice Smith. He has stated the reasons for the conclusion of the majority on this subject with great

cogency and clearness and has cited the authorities to sustain the views there expressed. I know of no authorities to the contrary. I wish, therefore, to express my unqualified concurrence in all that he has said of the meaning of the words 'underwriting profit' used in the statute. *From my viewpoint, there is no well-founded room for a difference of opinion.*

Moreover, even if there had been no testimony in the record explaining the meaning of the technical term 'underwriting profit' this court applying business principles and correct rules of accounting could have only reached the same conclusion without the aid of the testimony of insurance rate experts, that it has arrived at with such aid. For, to my mind, applying to the insurance business sound rules of bookkeeping and accounting—the test applied in any ordinary business—the premiums earned represent the actual income or profits and the losses incurred (which includes expenses) represent the losses. Therefore, deduct from the premiums earned the losses incurred, during any given period, and the result will show the net profit or loss for such period. *For any given period this method represents a closed business transaction, and is a sound rule of computation. Any other would be mere speculation.* See the able opinion of the House of Lords and Privy Council in *Sun Insurance Office* v. *Clark*, House of Lords and Privy Council, Appeal Cases (1912) p. 443." (Italics are ours.)

In the majority opinion, in the case at bar, it is argued that the earned and incurred method is wrong, because "when the companies are prosperous and their business is increasing in volume, according to the earned method they show a loss, whereas when their underwriting is falling off they show a profit" (R. 3018). The assumption that increased premium income means prosperity does not follow, because with the increased premiums come increased losses and expenses; and if the latter consume the former, there is no prosperity. The foregoing statement by the court is founded upon the evidence of the Superintendent's witness, Metice, who hypothetically transposed the petitioners' premiums written in 1917 and 1921, and those written in 1918 and 1920,

leaving 1919 figures the same, and assumed further a transposition of the unearned premium figures at the beginning and end of each year of the five year period; and, based on these assumptions, testified that the companies on such descending scale of business would have realized a profit of $9,992,508 (R. 2227). The conclusion of the witness is utterly fallacious for these reasons:

(*a*) The unearned premiums at the end of any given year represent the unearned portion of the premiums written during that year plus what is still unearned from the premiums of previous years. To transpose the figures so that the unearned premiums at the end of a year are placed at the beginning of the year and those at the beginning of the year are placed at the end of the year creates an impossible relation, because in this way the unearned premiums from the business of the given year are placed at the beginning of the year, or before the business was *actually written*. For example, in the year 1919 (shown in McGee's Table A, R. 2227) the unearned premiums at the beginning of the year were actually $10,612,159, and at the end were $12,628,009. It will thus be seen that as an actual fact the unearned premiums were approximately $2,000,000 greater at the end of the year than at the beginning. In his Table B, illustrating the transposition, the unearned premium at the beginning is stated at $12,628,009, and at the end, instead of being an increased figure is a reduced figure of $10,612,159—*an obviously impossible and preposterous figure.*

(*b*) Mr. McGee assumed an unearned premium figure at the end of the five-year period of $8,373,804. In point of fact, upon the volume of business written in the five-year period as he assumed it, the unearned premium at the end of the five-year period would have been a tremendously increased figure.

(*c*) He assumed the incurred losses and expenses of the five-year period to have been $82,198,078. In fact upon the

volume of business which he assumed, the losses and expenses incurred would have been greatly increased over that sum. His assumption that there was increased business prior to 1917, overlapping into the five-year test period, necessarily would mean losses upon such overlapping policies.

The juggling transposition of figures by Mr. McGee proves nothing. The assumptions he makes being impossible, necessarily his conclusion is wrong. The fact is that if the business had been on a descending scale, as he assumes, the unearned premium figure at the end of each year and of the period, and the losses and expenses incurred during that period, would have been so vastly increased over the figures he states in his tabulation that substantially the same underwriting loss would have been produced as was in fact produced.

Whether business is on an ascending or descending scale, the fact remains that the earned and incurred method charges the companies with every dollar of premium which they earn during the test period; and this is all that in reason should be charged. The received and paid method charges them with every dollar of premiums received, whether earned or not, and regardless of whether they ever will be earned. The method is wrong for that reason. It completely ignores the reserve requirements of the statute, and the conceded fact that 20% to 25% of all premiums received are ultimately returned to policyholders on cancellation (R. 972-3, 733, 1360-1, 1580). Apparently overlooking this fact, the opinion below erroneously says that the possibility of cancellation "is so remote as to be negligible" (R. 3021).

The majority opinion concedes that the received and paid method is not indicative of solvency, and does not properly represent net earnings for the purpose of distribution of assets upon dissolution, yet nevertheless holds that it does reflect the "clear earnings of the period embraced, if that period be considered apart from those which preceded it and those which follow" (R. 3019). The "earnings" of a period

are certainly not "clear" if a substantial per cent of such "earnings"! are tied up in a reserve, and a large portion will ultimately have to be surrendered to policyholders (R. 1660-1).

The majority opinion argues that certain insurance companies in previous dealings with the Missouri Insurance Department have heretofore employed the received and paid method in their application for increase of rates (R. 3019). It is true the evidence shows that the Missouri Superintendent of Insurance has chosen to make calculations of underwriting profit upon the received and paid basis (R. 2302, 2744, 2837-8); and that the insurance companies in two previous applications for increase of rates, one in 1915 (R. 2833-5) and one in 1918 (R. 2311) conformed to such view by submitting their underwriting experience upon the received and paid basis. However, it is apparent from the record that the reason for this was because the Superintendent insisted upon this theory, and the insurance companies chose to deal with him upon his own basis; and because even upon such theory, which was more favorable to the state than the earned and incurred basis would have been, the companies were found entitled to the increases asked (R. 2835, 2330-3.) Since that time other companies have entered the state which had no part in such action.

It is a sufficient answer, moreover, to say that the Superintendent, as a rate regulating official, cannot substitute for a reasonable rate a lower rate, on the ground that the insurance companies by their former conduct have become estopped from charging a reasonable rate. *Southern Pacific R. R. Co.* v. *Interstate Commerce Comm.*, 219 U. S. 433.

In addition to this, the question as to the proper method of calculating underwriting profit is a question of law, in this case of constitutional law, and the position of the insurance companies upon this question in their previous dealings with

the Insurance Department is at most nothing more than the expression of an opinion upon a question of law. Under such circumstances there is no estoppel (*Sturm* v. *Baker*, 150 U. S. 312, l. c. 335-7; 14 Sup. Ct. Rep. 99, 37 L. Ed. 1093; 21 C. J. 1147; 22 C. J. 296, 333, 343, 423, 425; *Race* v. *Kurk*, 163 App. Div. 924, 147 N. Y. Supp. 818; *Raulins* v. *Neal*, 122 N. C. 173, 29 S. E. 93.)

In the opinion below it is said that the stand now taken by the petitioners upon the earned and incurred method has the appearance of having been "contrived for the purpose of this case" (R. 3019-20). *Nothing could possibly be further from the fact.* The rate reduction order here in question was made October 9, 1922 and this suit was filed November 10th of the same year (R. 9). Two years before that most of these petitioners had filed suit in Arkansas to review a rate reduction order made in 1920, contending (successfully) that the earned and incurred method should be adopted (*Bullion* v. *Aetna Ins. Co.*, 151 Ark. 519). Not only so, but in December, 1921, a year before this suit was filed, the insurance commissioners representing all the forty-eight states, after a two years investigation of the question, had adopted the earned and incurred method as the proper method of calculating underwriting profit (R. 825-35); and for a great many years all the states including Missouri, had used the method in annual statement blanks (R. 2141-2, 2133, 2291-2, 181, 709, 863, 2806-7, 2850-1). The same method had been adopted in the collection of income tax by Congress (Sec. 246 of Revenue Act of November 23, 1921) one year before, and by Great Britain (*Sun Insurance Office* v. *Clark*, *supra*) ten years before this suit was filed. And as pointed out above, the testimony of a host of witnesses in the record shows that the use of the earned and incurred method *is as old as the insurance business itself, and is universal, and that no company calculated its profits for its own information on any*

other basis. The record therefore does not support, but affirmatively disproves, the assertion in the opinion that the earned and incurred basis is a method "contrived for the purposes of this case."

The majority opinion argues that it is improper to exclude unearned premiums from consideration, and yet to include the expense incurred in acquiring the business which produced such unearned premiums (R. 3020, 3022). The opinion states that the cost of procuring insurance is approximately 40 per cent of the premium paid, and that this 40 per cent is deducted as expense incurred whereas the unearned premiums are excluded from income, under the earned and incurred method (R. 3020). The opinion errs in stating that the cost of procuring insurance is approximately 40 per cent, the record showing the average total expense to be 42 per cent (R. 1645), and the average agent's commission to be 22 per cent to 25 per cent (R. 114, 313, 771-2, 999, 1319, 1556); and usually the agent's commission is the greatest part of expense paid in the year in which the business is written (R. 1630). Passing that, we submit there is nothing improper in rejecting premium income *for which value has not yet been delivered, or in taking into* account expenditures in fact incurred, during a test period (R. 1006-7, 1013-14, 1022-3, 1498-9). Furthermore, the exclusion of unearned premiums from the income of a given year is offset by premiums received in previous years becoming earned in the given year (R. 1069, 1753, 2130).

But even if it were conceded that there is any injustice in including as a part of the incurred expenses of the test period the cost of acquiring premiums unearned in said period, certainly there is no warrant in reason for excluding in this case a greater proportion of the total expenses incurred ($33,230,352) than the ratio which premiums unearned in the period ($8,888,365) bear to premiums received in the period ($83,502,181). Applying this theory to the experience of the

test period would lead to this result: On the earned and incurred basis the petitioners' experience was as follows (R. 3007):

Earned Premiums		$74,813,816
Incurred Losses	$48,593,664	
Incurred Expenses	33,230,352	
Incurred losses and expenses combined		81,824,016
Underwriting loss (9% of earned premium)		$ 7,010,200

Reducing the expenses incurred ($33,230,352) to the extent indicated, would reduce the underwriting loss $3,537,195, and would still leave an underwriting loss of $3,473,005. The rate order would, if in effect, have greatly increased such loss.

The majority opinion says that if the received and paid method is faulty the insurance companies cannot complain "because their accounts afford no other way" (R. 3022). The majority opinion is in error in this statement, the evidence being unqualifiedly to the contrary (R. 704-5). And as above pointed out, the annual statements made to the forty-eight states require a report of underwriting profit on the earned and incurred basis; and necessarily the accounts of the companies are kept in such a way that this report can be made.

We earnestly submit that in applying the received and paid method the opinion below adopts a method of calculation which is unreasonable, fundamentally erroneous and confiscatory; and that by the reduction in rates based thereon the petitioners are deprived of their property without due process of law in violation of the Fourteenth Amendment.

II.

The rate reduction order and the opinion below in so far as they apply $2,301,132 interest earnings from investments to a reduction of rates for underwriting, are confiscatory.

1. The rate reduction order and the opinion treat all premiums received during the test period as income (R. 3034-5.) The effect of this is to treat all premiums earned or unearned as income, that is, as the unqualified property of petitioners held for the benefit of their respective stockholders.

Notwithstanding this holding, the opinion also treats as underwriting income the sum of $2,301,132 interest derived from the investment of corporate assets, being such part of such interest earnings as is considered in the opinion to be interest upon unearned premiums (R. 3033-8.) Thereby the opinion takes interest derived from the *investment of petitioners' unqualified assets* and applies the same to a reduction of rates for *underwriting*.

That unearned premiums are impressed with some kind of a trust relationship, giving the policyholder an interest in a sense different from other general creditors, has been often asserted and in every such case held to be an unsound position.

> "What is the right of the assured under his contract of insurance? To have indemnity in case of loss, nothing more. What is the obligation of the insurer? To indemnify in case of loss. Nothing more. If no loss occur, the assured takes nothing by the contract and the insurer loses nothing. It is, therefore, plain that unless a loss occur, the relation of debtor and creditor does not exist."

Insurance Co. v. *Capellar*, 38 Ohio St. 560.

People ex rel Westchester v. *Trustees*, 91 N. Y. 574.

State v. *Parker*, 35 N. J. L. 575.

Hynicka v. *Union Central*, 17 Ohio Dec. 80; aff'd 18 Ohio Dec. 1; aff'd 78 Ohio St. 432.

State ex rel Peoples Fire Ins. Co. v. *Receiver of Taxes*, 34 N. J. L. 479.

Kenton Ins. Co. v. *Covington*, 86 Ky. 213.

People v. *Feitner*, 166 N. Y. 129, 59 N. E. 731.

Equitable Life Assurance Co. v. *Brown*, 213 U. S. 25.

In a recent case decided by the Supreme Court of Oklahoma, it is said:

> "The contributions of the stockholders and the earnings of the company other than premiums, may as well be said to belong to the policyholders as the assets to the extent of the reserve, belong to them. So far from being the owner, it does not appear that the policyholders have a lien upon any particular part of the property or assets of the corporation or that their right therein is different from that of the creditors. We, therefore, conclude that the portion of the assets which represents the premium is as much the property of the coroporation as the portion which represents the contribution of the stockholders or funds derived from other sources."
>
> *In re*: Oklahoma Ins. Co., 68 Okla. 216 (173 Pac. 37).

The Supreme Court of Pennsylvania has similarly held and says:

> "There is no provision of law requiring that the companies' assets or any part thereof shall be set aside for the benefit of its policyholders and they are not so separated, but as a matter of bookkeeping, a separate account is kept as to that side of the business. Its contracts with its policyholders give them no claim upon any particular assets. Losses are paid out of the general fund, the fund is under the absolute control of the company and was created to meet future indebtedness."
>
> *Prov. Life* v. *Durham*, 212 Pa. 68 (61 Atl. 636).

There is a fundamental inconsistency in holding (*a*) that unearned premiums are accrued income and therefore the unqualified property of the petitioners, and (*b*) that inter-

est earnings from the investment of such unearned premiums can be applied to a reduction of rates for underwriting. If unearned premiums are profits belonging to petitioners' stockholders so as to be classed as earnings for rate-making purposes, then the interest derived therefrom is pure *investment* income and not in any sense *underwriting* income; and the same cannot be applied toward a reduction of underwriting rates.

The majority opinion in the case at bar concedes that interest earnings from the investment of *capital and free surplus* constitutionally cannot be treated as income in fixing underwriting rates (R. 3012, 3023-4). Yet interest earnings from assets representing unearned premiums, which under the majority opinion are free surplus, are treated as held for policyholders and not for stockholders.

The dissenting opinion makes the inconsistency clear in the following language (R. 3044-6):

> "The interest earnings on so much of the companies' assets as would be consumed in reinsuring all of their risks are no more attributable to the underwriting business than are the earnings on the remainder of their assets, and it is conceded by the opinion that the latter can not be taken into consideration in determining underwriting profits. If, however, the view that interest on unearned premiums should be charged up to the insurer in determining his underwriting profits be the correct one, then the method of arriving at profits which takes unearned premiums into account is wrong. Unearned premiums, in whole or in part, cannot be reckoned as profit and at the same time the insurer be required to pay interest on it to the policyholder.
>
> There is but one theory consistent with the companies' constitutional rights upon which it can be held that they must account for interest on unearned premiums, namely: that the premiums, being paid in advance, must be regarded as in a sense the moneys of the policyholders until earned by the lapse of time. *For if the premiums as soon as they are received by an insurer become without qualification his absolute property, then certainly he can*

not be required to pay to the policy holders interest on them, or, what is tantamount thereto, apply such interest to the reduction of the cost of their insurance. *Such a requirement in that view would be plain confiscation.* And if the premiums belong to the policyholders until earned, then until that time arrives the insurer can not strike a balance for the purpose of ascertaining his profits. *In other words, if the interest on unearned premiums enter into underwriting profits, such profits must be determined upon the earned premium basis.* * * * *But be that as it may, it is clear to my mind that the majority opinion is wrong in holding on the one hand that underwriting profits must be determined upon the basis of premiums received, which includes both the earned and unearned and on the other hand that interest on unearned premiums must be taken into account.*" (Italics ours.)

2. The insurance companies have two separate and distinct activities, underwriting and investments (R. 1530, 745, 770, 823, 842, 959, 989-90, 1320-2, 2848.) Each is productive of a profit or a loss. The opinion in effect concedes that the evidence as to the separate character of these activities is undisputed (R. 3011-12.) The National Convention of Insurance Commissioners has recognized it by ruling that "no part of the so-called banking profit or loss should be considered in arriving at underwriting profit or loss" (R. 831.) Congress has recognized it by levying income tax separately upon investment income and underwriting income (Sec. 246 of the Revenue Acts of 1921, 1924 and 1926. The blanks upon which the petitioners make annual statements to the forty-eight states also recognize it by requiring separate statements of underwriting experience and investment experience (R. 1285-90, 2145). The line of cleavage is as distinct as between the freight and passenger traffic or the interstate and intrastate traffic of a railroad, or the gas and electric business of a public service company.

Fundamentally the question is one of operating account, the receipts and the outlays. The receipts are the earned

premiums, the outlays are the losses and expenses. That is the business of underwriting. And when these operations show a loss a rate reduction order cannot be justified by compelling the companies to resort to their returns from investments.

The majority opinion takes income derived from one department (investment) and applies it to a reduction of rates for service in a distinct department (underwriting). This is plainly confiscatory. The effect of this holding is to require petitioners to do their underwriting business at rates which will result in loss, or yield less than a reasonable profit, on the theory that by the application of interest earnings from another department (investment) such loss or deficiency in profit may in whole or in part be overcome. This is a clear denial of due process.

The state cannot justify unreasonably low rates for under writing, considered alone, upon the ground that the insurance companies are earning income from investments (over which the state has no control in the making of rates) sufficient to overcome the loss in underwriting. The insurance companies are entitled to rates sufficient to make their underwriting activity, standing alone, reasonably profitable.

Prepayment of insurance premiums does not differ in principle from the purchase of a round-trip railroad ticket upon a railroad, which may be used for a return trip. That the buyer of the ticket is entitled to interest for such prepayment has never been contended by anyone. What the owner of the ticket is entitled to is a service, and so long as the railroad remains solvent and is able to perform the service, the ticketholder has no complaint arising out of prepayment for his ticket, even equitably for he has received a price lower than another person who purchased one-way tickets.

In the same way a reduction of premium charges is granted on term policies, the five-year policy being issued for four

times the annual premium, and the three year policy for two and one-half times the annual premium.

In fact, no such separate and distinct thing as "interest on unearned premiums," as distinguished from surplus, exists or can exist. Interest on unearned premiums is merely an increment of what is virtually a contingency reserve with respect to future obligations. It is set up out of surplus augmented by premium receipts. In the future, this may be entirely absorbed by losses, and this only the future can tell. The division of premiums into earned and unearned premiums at a given date is a rational division, not of the existent proceeds of premiums from policyholders, but a bookkeeping division used as a means of segregating an income period as of given dates so as to sever it from that which precedes and that which follows it.

That some such method is controllingly necessary arises out of the fact that premiums are not all written upon the same date, for the same period of time, but are written from day to day for varying periods.

The viewpoint of the Supreme Court of Missouri, in treating as additional income what is styled "interest on unearned premium," is unsound in its view of the nature of the unearned premium reserve. The Supreme Court of Missouri proceeds upon the assumption that if this sum is set up as a liability in the annual statements of account of the companies, that this is a recognition of a liability to policyholders, creative of debt to them. Such is not the nature of this reserve.

In the case of *Charles V. Duffy, Collector, petitioner* v. *Mutual Benefit Life Insurance Company*, 272 U. S. 613, this court said of a life insurance reserve:

> "True, the amount of the reserve as carried on the books is a liability, but only as the capital stock of a corporation as carried on its books is a liability. In both instances, it is a form of bookkeeping to balance assets. * * *"

The unearned premium reserve, set up as a liability in annual statements, is such a bookkeeping balancing figure. It shows obligations to policyholders, (as of a date and not for a term) not to pay them any money—except in the contingencies of cancellation—but to furnish indemnity and service. So far as the policyholder might be entitled to some equitable consideration for prepaying his premiums, this is fully met by the fact that policyholders taking three-year policies pay two and one-half times an annual premium, and five-year policyholders pay four times an annual premium for their insurance. They are given a reduction, by virtue of which they pay the present value of the annual installments which otherwise they would pay. After they have paid their premium, they are entitled to nothing but service and indemnity. If the Company places the money conservatively at interest, speculates with the money and makes or loses a large sum, or keeps it in cash and received no return upon it—none of these matters are any concern of the policyholders so long as the company remains solvent and able to discharge its obligations. The essential difference between a mutual company and a stock company is that in a mutual company the members share the profits; in a stock company, the profits go to the stockholders and not to policyholders. A further element for consideration is, that the unearned premium reserve is not all out at interest, but a part of it is necessarily in cash and agency balances and other uninvested forms; and still further, it is in a large part made up from free surplus, entirely distinct from current premium income. (R. 956.)

All these considerations aside, there is another conclusive reason why interest on unearned premiums is not proper to be taken into account, and that is the fact that gains by way of interest on invested moneys are not *profits* from the operation of the business of insurance. The first question to be determined in a rate case is whether the actual operating

outgo is greater than the operating income. That is the case here and that we submit nullifies the rate reduction order.

Insurance is as purely a service as is the case of a commission merchant who buys and sells apples in carload lots upon railroad tracks. He receives a percentage upon the value of the property handled for his service. Whether he is the owner of large properties, or has only a nominal capital, has no bearing on the commission which he charges the person for whom he handles the product.

The controlling principle governing this case has been frequently and uniformly applied by this Court in analogous cases, one of which is *Smyth* v. *Ames*, 169 U. S. 466, l. c. 540. 541, (the Nebraska rate case). In that case the state rate-making body undertook to justify inadequate intrastate rates by taking into account the railroad companies' income from interstate business. This Court said, l. c. 541:

> "If we do not misapprehend counsel, their argument leads to the conclusion that the State of Nebraska could legally require local freight business to be conducted even at an actual loss, if the company earned on its interstate business enough to give it just compensation in respect of its entire line and all its business, interstate and domestic. We cannot concur in this view. In our judgment, it must be held that the reasonableness or unreasonableness of rates prescribed by a State for the transportation of persons and property wholly within its limits must be determined without reference to the interstate business done by the carrier, or to the profits derived from it. The State cannot justify unreasonably low rates for domestic transportation considered alone, upon the ground that the carrier is earning large profits on its interstate business, over which, so far as rates are concerned, the State has no control. Nor can the carrier justify unreasonably high rates on domestic business upon the ground that it will be able only in that way to meet losses on its interstate business. So far as rates of transportation are concerned, domestic business should not be made to bear the losses on interstate business, nor the latter the losses on domestic business. It is only rates for the transportation of persons and prop-

erty between points within the State that the State can prescribe; and when it undertakes to prescribe rates not to be exceeded by the carrier, it must do so with reference exclusively to what is just and reasonable, as between the carrier and the public, in respect to domestic business."

The same principle was again decided in the *Minnesota Rate Cases*, 230 U. S. 352, l. c. 435.

The argument was made by our opponents in the court below that the companies have large incomes from their investments. As these reserves have in many cases been built up over a period of 100 years, the suggestion is of no importance.

In the recent case of *Board of Public Utility Commissioners* v. *New York Telephone Co.*, 271 U. S. 23, the state rate-making commission undertook to justify confiscatory rates by the application of a reserve built up from past operations. This Court held that this could not be done. The court said, l. c. 366:

"The customers are entitled to demand service and the company must comply. The company is entitled to just compensation and, to have the service, the customers must pay for it. The relation between the company and its customers is not that of partners, agent and principal, or trustee and beneficiary. *Cf. Fall River Gas Works* v. *Gas & Electric Light Com'rs*, 102 N. E. 475, 214 Mass. 529, 538. The revenue paid by the customers for service belongs to the company. The amount, if any, remaining after paying taxes and operating expenses including the expense of depreciation is the company's compensation for the use of its property. If there is no return, or if the amount is less than a reasonable return, the company must bear the loss. Past losses cannot be used to enhance the value of the property or to support a claim that rates for the future are confiscatory. *Galveston Electric Co.* v. *Galveston*, 42 S. Ct. 351, 258 U. S. 388, 395, 66 L. Ed. 678; *Georgia Ry.* v. *R. R. Comm.*, 43 S. Ct. 680, 262 U. S. 625, 632, 67 L. Ed. 1144. And the

law does not require the company to give up for the benefit of future subscribers any part of its accumulations from past operations. Profits of the past cannot be used to sustain confiscatory rates for the future."

Other cases applying the same principle are as follows:

Northern Pacific Ry. Co. v. *North Dakota*, 236 U. S. 585, l. c. 599.

Vandalia R. R. Co. v. *Schnull*, 255 U. S. 113.

Norfolk & Western Ry. Co. v. *West Virginia*, 236 U. S. 605.

Brooks Scanlon Co. v. *R. R. Comm. of La.*, 251 U. S. 396.

Interstate Commerce Comm. v. *U. P. R. R.*, 222 U. S. 541, 549.

The only operation of insurance companies the income of which may be controlled by the state is income from insurance. Income from investments is distinct and the allowable income thereon is not subject to limitation by the state. The operation which is clothed with a public interest is that of insuring property owners. The operating income of insurance companies consists of premiums and nothing else.

In the *Minnesota Rate Cases*, 230 U. S. 352, the Court had for consideration the validity of orders of the Minnesota Railroad and Warehouse Commission and legislative Acts of the State of Minnesota prescribing maximum freight and passenger rates applying within the state. In consideration of this case and its bearing upon the business of the Northern Pacific Railway Company, one of the parties to the suit, the Court found that a holding of the Warehouse Commission and the inferior courts rested upon the values of certain investments of the Northern Pacific Railway Company, and the Court said (l. c. 440):

"These securities and their value in the market rest upon the entire property of the company. They include assets of considerable value (for example the stock of

the Northwestern Improvement Company, owning extensive coal lands), *which, however, do not form a part of what may be called the operating property of the company or that devoted to the public service, upon which the fair return is to be calculated.* Referring to the market value of the securities the master said:

"'Assets and property not devoted to public service have not been valued, and as they are a large element in stock valuation it follows that value of bonds and stocks is wholly unreliable and cannot be used in these cases as an element in determining the value of operating property or as a basis for rate making.'

"In this view the master was undoubtedly right." (Italics are ours.)

Insurance companies may invest their money or keep it in cash to meet their liabilities as they choose. If they decide to invest their money, it is a private transaction between the companies and those to whom they lend.

In *State* v. *Spokane R. R. Co.*, 89 Wash. 599, 154 Pac. 1110, the court had for consideration regulations of rates of a traction company operating a street railway system pursuant to franchise. In addition to this public function they sold their excess power, developed as an incident, to private users of electricity and light. The Legislature of the State of Washington passed an act creating a Public Service Commission, who were empowered to regulate public service properties and utilities. The Court, in denying that the right was or could be given the Commisson to pry into amounts derived from sale of excess power, said:

"The Commission insists that it cannot find a basis for rate making without knowing the private as well as the public affairs of appellant. Granting that the appellant is entitled to a fair return upon its investment and the public to a fair rate of transportation, *to hold that respondent could figure appellant's private contracts as a basis for rate making would in turn compel the holding that appellant would be entitled to take from the public enough to make good its losses in its private enterprises.*

> ***The state has no interest in appellant's gains or losses in its private enterprises.*** It has not yet assumed to stand as an inquisitor or conservator in private business."

We respectfully and earnestly submit that there is no escape from the proposition that the application of interest earnings from investments to a reduction of rates for insurance, is confiscatory and a denial of due process. The case falls squarely within the principle applied by this court in the cases cited *supra*. Petitioners are entitled to rates sufficient to make their underwriting activity, standing alone, reasonably profitable. They may not, consistently with due process, be compelled to issue insurance policies for less than a reasonable profit, on the ground that by the application of investment earnings, they may make up their losses.

In the effort to sustain the inclusion of investment earnings, the majority opinion points out that Sec. 6281, R. S. Mo. 1919, requires petitioners to *report* to the Superintendent the "earnings on unearned premiums," and argues, "Why put it in the law if the Superintendent was not to consider it in making rates? * * * We regard that statute as a legislative determination that interest on unearned premiums is an underwriting profit, for the legislative body had no concern about any other kind of profit." (R. 3028.)

A complete answer to the foregoing statement of the court is, that the State has no power, either by legislative fiat, by declaration of the superintendent of insurance or by decision of its supreme court, to confiscate petitioners' property by a reduction of underwriting rates by resort to income from investments.

III.

The deduction from petitioners' expenses of the sum of $2,496,715 commissions paid to their St. Louis agents, is unreasonable and confiscatory.

In ascertaining the alleged profit for the test period, the opinion below deducts from expenses the sum of $2,496,715 excess commissions, to-wit, commissions paid to St. Louis agents upon a scale higher upon the average than that in force in the rest of the state. This deduction is based upon the alleged ground that the excess commissions were unreasonable expenses, and that petitioners should not have incurred them (R. 3032-5).

The excess commissions were a necessary expense (R. 772, 1741, 1770-1, 1772, 1778). The St. Louis agents, because of the higher cost of operating insurance agencies in that city as compared with the cost in the rest of the state (R. 785, 1610-11), and because of extra service furnished (R. 1481-3, 1610-11) and greater brokerage commissions paid (R. 785-6, 1481-3, 1610-11, 1767), have for many years exacted from petitioners a higher scale of commissions than are paid elsewhere in the state (R. 1741, 1767). This increased scale is an expense which, according to the best judgment of petitioners' officers, is reasonable (R. 1770-2, 1778). Petitioners competing one with another are necessarily compelled to pay this expense or cease doing business in St. Louis. It is forced upon them by competition (R. 725, 772, 1557).

It is all very well for the Superintendent by a stroke of the pen to attempt to change the method of doing business which has existed for over fifty years. But as a practical matter it cannot be changed as easily as that. Excess commissions in the larger cities present a condition, not a theory, and the companies are compelled to pay them if they expect to do business there. These commissions are a part of the

cost of acquiring business, and are operating expense the same as the lower scale commissions paid in Sedalia or Springfield.

The Superintendent has taken the position that the policy adopted by the insurance companies, of paying scales of commission to agents sufficiently large to enable the agents to pay brokerage fees, to make specialized inspections and surveys, etc., (which policy was in general pursued in St. Louis,) would be better abandoned. It was the position of the Superintendent that the method of conduct of the business by the insurance companies was not one which he would adopt in his position of self appointed manager of the insurance companies. Their judgment meeting with his disapproval, he therefore disallowed such expenditures, and the Supreme Court of Missouri has approved his action.

By the stringent anti-trust laws of the State of Missouri, the insurance companies could not combine and agree on a course of conduct toward their agents without violation of the anti-trust laws of the state. It may be readily surmised how successful the action of individual companies would be should they refuse to pay brokerage fees and standardized commissions in St. Louis, which all their competitors did pay. The simple result would be, as to any company refusing to allow for brokerage fees, that it would get no business and have no agents. The Superintendent prescribed the policy, nevertheless, which he believed the companies ought to follow, and as a penalty for any refusal to do so enforces his action by refusing to admit as outgo the items of expense which he deems an improper and unwarrantable expenditure.

The payment of excess commissions so-called was the result of competition in business getting which none of the competitors, individually, could correct, for the result of its refusal to pay a demanded commission scale in St. Louis would result in its having no business and no agent. Commissions are not uniform, some companies pay more and some less than their

competitors. Neither could the companies combine to change the practices without violating the anti-trust laws of the state. Neither is there any showing that it would be either practical or desirable or fair to agents to change the existing commission scale. The Superintendent had no power to make any direction as to what commissions the company should pay, and the legislature had no constitutional authority to take the management of the business out of the hands of its owners.

In the case of *State ex rel. Woodmen Accident Company* v. *Conn. Superintendent of Insurance*, 156 N. E. Rep. (Ohio) 114, the court held void and unconstitutional a statute of the State of Ohio limiting the expense of management of foreign insurance companies to 30 per cent. The court held the statute unconstitutional as a denial of equal protection of the laws and, in the course of the opinion, among other things say:

> "The contracts of insurance or policies issued by relators are based upon the payment of the premium, assessment or membership fee to the company and the liability of the company is predicated thereon. These premiums, assessments and membership fees are the property of the company. They are in no sense the property of the agent who collects them. The amount paid the agent for their collection is a matter of special contract between the company and the agent and may vary in different parts of the state as circumstances justify. The amount is what the company has to pay for its collections made, and while the record in this case does not show other than a uniform rate, it is a part of managing the affairs of the company and being a subject of private contract between the company and its representative it may be a large, small or reasonable amount as those in charge of the management of the company may contract."

There is nothing in the record to indicate bad faith or abuse of discretion in the payment of this expense. The petitioners have exercised a proper discretion about the matter, which is one requiring business judgment. The legislature

is not entitled to substitute its judgment for the honest discretion of the officers and directors of the petitioner companies. It cannot, consistently with the due process clause, order a rate reduction based upon arbitrary rejection of this expense from the profit calculation.

This court has laid down the principle in *Southwestern Bell Telephone Co.* v. *Public Service Commission*, 262 U. S. 276, l. c. 288-289, as follows:

> "There is nothing to indicate bad faith. So far as appears, plaintiff in error's board of directors has exercised a proper discretion about this matter requiring business judgment. It must never be forgotten that while the state may regulate with a view to enforcing reasonable rates and charges, it is not the owner of the property of public utility companies and is not clothed with the general power of management incident to ownership. The applicable general rule is well expressed in *State Public Utilities Commission ex rel. Springfield* v. *Springfield Gas and Electric Company*, 291 Ill. 209, 234:
>
> "'The commission is not the financial manager of the corporation and it is not empowered to substitute its judgment for that of the directors of the corporation; nor can it ignore items charged by the utility as operating expenses unless there is an abuse of discretion in that regard by the corporate officers.'"

To the same effect is *Houston* v. *Southern Telephone Company*, 259 U. S. 318, l. c. 323. In *Ohio Utilities Co.* v. *Public Utilities Commission*, 267 U. S. 359, l. c. 363, the action of the state commission in arbitrarily deducting expenses incurred, was reversed because arbitrary and unreasonable. In *Boston* v. *Belt Line Ry.*, 268 U. S. 413, l. c. 421, it is held that "subject to reasonable regulation in the public interest, the management and right to control the business policy of the company belong to its owners." As this court said in *Dayton-Goose Creek Ry.* v. *United States*, 263 U. S. 456, l. c. 483:

> "The investment is made on the faith of a profit, the profit accrues from the balance left after deducting ex-

penses from the product of the rates, *and the assumption is that the operation is economical and the expenditures are reasonably necessary.*" (Italics ours.)

See also *Wolff Packing Co.* v. *Court of Industrial Relations*, 262 U. S. 522, holding that a state may not dictate to an owner the amount of wages he must pay.

These excess commissions have been forced upon the insurance companies by legitimate competition. In the case of *Interstate Commerce Commission* v. *Chicago Great Western Railway Company*, 209 U. S. 108, l. c. 118-119, the railway company was charged with unlawful discrimination in carrying dressed beef at a cheaper rate than live stock. The railway asserted in defense that its action was induced by competition. This court upheld the defense, and held that the railroads were free "to manage their important interests upon the same principles which are regarded as sound and adopted in other trades and pursuits."

State v. *Minneapolis, etc., R. R.*, 80 Minn. 191 (83 N. W. 60).

L. & N. R. Co. v. *U. S.*, 238 U. S. 1.

The State has not the power to direct what the insurance companies shall pay their officers or agents for salaries or commissions, but must leave those matters to competition and self-interest. The relations between an insurance company and its employees are its private affairs and are not a matter of any direct concern to the public. To say that they indirectly concern the public where the matter indirectly affects rates would extend the doctrine of *German Alliance Ins. Co.* v. *Lewis*, to warrant the implied power of inquiry as to the propriety of maintenance of rating bureaus and organizations maintained by insurance companies, their wasteful or efficient management, whether agents might not better be paid salaries in place of commissions and what those salaries should be, whether the cost of inspection of properties

might not be conducted through other or more efficient agencies or eliminated entirely, how much the cost of insurance is increased by valued policy laws and other cost producing facts, whether adjustments are conducted as economically as should be and innumerable like inquiries. All these inquiries infringe upon the rights of the companies to manage and conduct their affairs according to the judgment of their officers and managers without interference from the State. In *Northwestern Natl. Ins. Co.* v. *Fishback*, 130 Wash. 490, 228 Pac. 516 (Sup. Ct. Wash.) the court say:

> "But the contract of the agent with the company is not a contract which affects the public generally as does the business of insurance."

See also, to the same effect, *Welsh* v. *Maryland Ins. Co.*, 47 Okla. 933.

The regulation of such expenses is not a part of the legitimate exercise of the rate making power. The exclusion from expenses of the sum of $2,496,715 commissions in St. Louis is arbitrary, unreasonable and confiscatory, and a denial of due process.

IV.

The rejection of $628,123 war tax on premiums as an item of expense is unreasonable and confiscatory.

In determining whether the ten per cent reduction in rates is reasonable, the opinion below deducts from the expenses of the test period the sum of $628,123 war tax on Missouri premiums (R. 3034-5).

The evidence is without dispute that this sum was actually paid (R. 405, 411, 214, 529, 1952). The war tax was imposed by the Federal Government on premiums (Sec. 504-5, Act of Oct. 3, 1917; Sec. 503 (b), Act of Feb. 24, 1918), and the petitioners were compelled to pay it as a necessary incident to their doing business in Missouri.

1. This court has expressly held in *Galveston Electric Co. v. Galveston*, 258 U. S. 388, l. c. 399, that in calculating whether a given rate will yield a proper return, it is necessary to deduct from gross revenue the expenses and charges; and that "all taxes which would be payable if a fair return were earned are appropriate deductions. *There is no difference in this respect between state and federal taxes or between income taxes and others.*" (Italics ours.)

This principle is again announced in *Georgia Railway & Power Co. v. Railroad Commission*, 262 U. S. 625, l. c. 633, 43 S. C. Rep. 680, 67 L. Ed. 1144. The majority opinion below is in direct conflict with the rule thus announced.

2. The only ground assigned in the opinion below for excluding this item is that the law imposing the war tax was no longer in operation at the time the reduction order was made (the war tax statute was repealed by Sec. 1400, Act of Nov. 23, 1921); and that therefore the war tax should not be "listed as an expense in fixing future rates" (R. 3034).

This court will note that the rating act (Sec. 6283 R. S. Mo. 1919) grants power to reduce rates only upon the actual results of the elapsed test period, and does not authorize any conjecture that during the years following there may not be taxes as great or greater than those in effect during the period. As this court said in *Pacific Gas & Electric Co. v. San Francisco*, 265 U. S. 403, 44 S. C. Rep. 537, 68 L. Ed. 1075:

> "The problem was to ascertain the probable result of the specified rate if applied under well known *past* conditions, not to forecast the probable outcome of a proposed rate under *unknown future conditions.*" (Italics ours.)

Who can say that taxes in the future will not be greater than in the past, although they may be given some different name? The "War Tax" may be followed by a "Peace Tax." It may not even be said that wars will not occur in the future and taxes flow from that state.

A condition of the power to reduce rates is the judicial determination that there has been an unwarrantable profit in the past. Any other standard would be speculative and unconstitutional. As was said by Judge Brewer (later Mr. Justice Brewer), in the case of *Chicago & Northwestern Railroad Company* v. *Day*, 35 Fed. 866:

> "*But speculations as to the future are not guides for judicial action; courts determine rights upon existing facts.* Of course, there is always a possibility of the future; good crops may increase transportation business, poor crops reduce; high or low rates may likewise affect; *but the only fair judicial test is to apply the rates to the business that has been done in the past, and see whether upon that basis such rates will be remunerative or compel the transaction of business at a loss.*"

In sustaining the rate reduction, based upon a rejection of the item of $628,123 war tax, the opinion is confiscatory and denies petitioners due process.

V.

The opinion below in fixing 8% of premiums received, or $6,680,169, as a reasonable profit upon the business of the test period, is confiscatory, because it fails to make allowance for proper elements of income and outgo, and for reserve; the fact being that petitioners were compelled during the test period to set aside reserves in the average amount of $12,717,006, 60% of which was drawn from premiums received.

The opinion below fixes 8% of $83,502,181 premiums received, or $6,680,169, as a reasonable profit to petitioners for the test period (R. 3035).

It is important to note that this allowance is made without the court taking into account the unearned premium reserve which petitioners are compelled by law to set aside (Sec. 6222 R. S. Mo. 1919). The conclusions reached in the majority

opinion are summarized in a tabulation (R. 3034-5). From beginning to end, the tabulation makes no reference to the unearned premium reserve, and from reading the tabulation one would never suspect that the companies are required to set up such a reserve (R. 3034-5).

The unearned premium reserve at the beginning of the test period was $8,372,804 and at the end of the period was $17,061,209 (see Petitioners' Exhibit 1359 at R. 1925). So the average unearned premium reserve during the period was $12,717,016. This is substantially twice the amount of the reasonable "profit" fixed by the opinion below.

Sixty per cent of the reserve is drawn from premiums received, and the remaining forty per cent from free surplus (R. 838-9, 964, 1541-2). Sixty per cent of the average reserve for the five year period is $7,630,209. The opinion below fixes 8% of the premiums received, or $6,680,169 as the amount of a reasonable profit, but ignores the fact that an amount in excess of that sum was set aside out of premiums received as part of the reserve. *The proportion of the reserve drawn from premiums received would more than consume the entire "profit" allowed.*

It does not appear from what source the majority in the state court anticipates that the unearned premium reserve will be drawn. *They wholly failed to make any allowance for this very important and substantial factor.*

The opinion states that it "seems to be agreed that a reasonable profit is 5 per cent on the underwriting business done, with 3 per cent additional for conflagration hazard" (R. 3011). This is not an accurate statement of the record. The uncontradicted evidence offered by petitioners as to the amount of a reasonable profit is that 8 per cent of $74,813,816 premium *earned*, or $5,985,105, would be a reasonable profit (R. 983, 719, 771, 832, 851, 1176, 1230, 1487, 1547 1693-4). However it is important to note that this measure of a reasonable profit was based upon a calculation of underwriting

profit by the earned and incurred method (R. 851, 1231, 1693-4), under which method all proper items of outgo and the unearned premium reserve are set up *before calculation of profit*.

It is apparent that the majority opinion in fixing 8 per cent of premiums received as a reasonable profit, without making any provision whatever for the reserve, adopts a fundamentally erroneous and confiscatory method and deprives petitioners of property and liberty without due process.

Northern Pacific Ry. Co. v. *Department of Public Works*, 268 U. S. 39.

Ohio Utilities Company v. *Public Utilities Commission*, 267 U. S. 359.

Interstate Commerce Commission v. *Union Pacific Railroad*, 222 U. S. 541, l. c. 547.

Bluefield Water Works and Improvement Co. v. *Public Service Commission*, 262 U. S. 679.

Vandalia Railroad Co. v. *Schnull*, 255 U. S. 113.

Union Tank Line Co. v. *Wright*, 249 U. S. 275.

Brooks-Scanlon Co. v. *Railroad Commission*, 251 U. S. 396.

Northern Pacific Ry. Co. v. *North Dakota*, 236 U. S. 585.

VI.

The Rating Act (Sec. 6283, R. S. Mo. 1919) as now construed and applied by the Supreme Court of Missouri in the instant case, is unconstitutional, for each of the reasons assigned herein.

The rating statute as written was not attacked by petitioners but said statute as administered and justified by the Supreme Court of Missouri in the instant case was attacked as being in violation of the Fourteenth Amendment, in that

it deprives petitioners of their property without due process of law (R. 35, 37, 621-2, 2216-17, 2263-4). In such a situation the constitutionality of the statute as construed in the instant case is presented as a federal question.

As this court said in *Myles Salt Co.* v. *Iberia Drainage District*, 239 U. S. 418, l. c. 484:

> "It is true that the law of the state as written is not attacked, but the law as administered and justified by the Supreme Court of the state is attacked and it is asserted to be a violation of the Constitution of the United States. The question presented is Federal and the motion to dismiss is denied."

To the same effect see *Reagan* v. *Farmers' Loan & Trust Co.*, 154 U. S. 362, l. c. 390-391; *Greene* v. *Louisville & Interurban R. R. Co.*, 244 U. S. 499, l. c. 507; *Raymond* v. *Chicago Traction Co.*, 207 U. S. 20; *Castillo* v. *McConnico*, 168 U. S. 674, and *Old Colony Trust Co.* v. *Omaha*, 230 U. S. 100.

If petitioners are right in any or all of their points of attack upon the constitutionality of the rate reduction order, then for the same reasons and in the same respects the rating act, as construed and applied, is unconstitutional. The two propositions, while distinct, go hand in hand.

The rating act as construed cannot be upheld on the ground that it is a condition upon which foreign corporations may do business in the state, "because the Legislature did not attempt to reach the result in that way. A company lawfully doing business in a state is no more bound by an unconstitutional enactment than a citizen of the state" (*Carroll* v. *Greenwich Ins. Co.*, 199 U. S., 401 l. c. 409; *Cargill Co.* v. *Minnesota*, 180 U. S. 452).

No conditions can be imposed which are repugnant to the constitution of the United States. A state is without power to impose an unconstitutional requirement. (*Frost* v. *Railroad Commission*, 271 U. S. 583; *Terral* v. *Burke Construction Co.*, 257 U. S. 529; *Power Mfg. Co.* v. *Saunders*, 47 Sup.

Ct. Rep., 678, l. c. 680; *Fidelity & Deposit Co.* v. *Tafoya*, 46 Sup. Ct. Rep. 331; *Western Union Telegraph Co.* v. *Kansas*, 216 U. S. 1).

The Superintendent contends that by a stipulation, which was entered into between the Superintendent and the insurance companies in a previous suit brought to enjoin the enforcement of a *previous* rate reduction order, the petitioners in the present suit are precluded from challenging the constitutionality of the rating act as applied in the present case. That stipulation appears at pages 24 to 26 of the record. It was entered into in a previous suit, an injunction suit filed by petitioners attacking the constitutionality of the rating statute (Secs. 6283-6284, R. S. Mo. 1919). By such stipulation the previous rate reduction order was revoked by the Superintendent, the injunction suit dismissed, and it was agreed that the Superintendent would hold a hearing to investigate the necessity for a reduction in rates and that if based upon such investigation he should make an order reducing rates, the insurance companies would proceed to secure a review thereof and that in such review proceeding "the question of the constitutionality of Sections 6283 and 6284, Revised Statutes of Missouri, 1919, shall not be raised" (R. 26). Thereafter a hearing was held by the Superintendent, and the present rate reduction order was made, whereupon the present review proceeding was instituted.

It is not alleged by petitioners herein that the statute as written is unconstitutional, but it is alleged that the rate reduction order is unconstitutional, and that if the statute be so construed and applied as to validate such order, then such construction and application of the statute through the medium of such rate reduction order would deprive petitioners of their property without due process in violation of the Fourteenth Amendment (R. 35, 37).

The constitutionality of the rating act as written is not questioned in this record, and never has been. The conten-

tions are that the rate reduction order is confiscatory and violative of the Fourteenth Amendment, and that the statute, valid as written, is unconstitutional as construed and applied by the Missouri Supreme Court.

The situation therefore is precisely that which has caused this court to state the distinction as follows:

> "The law of the state as written is not attacked, but the law as administered and justified by the Supreme Court of the state is attacked, and it is asserted to be in violation of the Constitution of the United States."
>
> *Myles Salt Co.* v. *Iberia Drainage District*, 239 U. S. 478, l. c. 484.

It is therefore perfectly clear that the petitioners have not in any sense violated the stipulation. We are fortified in this assertion by the decision of the Missouri Supreme Court in *State ex rel. Hyde* v. *Westhues, Judge*, 290 S. W., l. c. 447, where the court, in referring to *this same stipulation*, said:

> "The stipulation of February 14, 1922, shows conclusively that the parties thereto had in contemplation the making of a new rate reduction order by the Superintendent of Insurance and the institution by the insurance companies of a new suit in the Circuit Court to review such order when made. After providing for the final disposition of the cause in which it was filed, the stipulation dealt solely with the new order and the new court proceeding to review it which the parties then had in mind. The agreement conferred no new powers on the Superintendent of Insurance with respect to making a new rate reduction order; it gave the insurance companies no additonal rights in respect to having such an order reviewed in a court of competent jurisdiction. The essence of the agreement was clearly this: The insurance companies waived their right to question the constitutionaltiy of Section 6283, as it then stood, and the Superintendent of Insurance consented that the companies might continue, pending the new suit, to charge and collect the rates as they were at the time of the making of the reduction order, upon giving a refunding bond. (Section 6284 then provided: 'During the pen-

dency of such action or review every insurance company or other insurer shall not charge any rate or premium in excess of that fixed by the Superintendent of Insurance.') On October 9, 1922, the new reduction order (of ten per cent) was made by the Superintendent of Insurance, and on November 10, 1922, the insurance companies instituted a suit in the Cole County Circuit Court to set it aside. This order and this suit were evidently the ones which the parties to the stipulation had in contemplation on February 14, 1922, and the ones with reference to which they stipulated, for at the very inception of the suit the court, with the consent of the parties, entered an order (heretofore set out) embodying what we have termed the essence of the agreement. *In the subsequent conduct of that proceeding the terms of the stipulation have, so far as appears, been observed in good faith on both sides.*" (Italics ours.)

VII.

If any single point of attack made by petitioners upon the rate reduction order is sustained, the order must fall.

Upon the figures adopted by the opinion below the rate reduction order is sustained by the very narrow margin of $607,040. The amount involved in each one of petitioners' points of attack upon the order is greater than that sum; so that if any one of petitioners' points is sustained, the order must necessarily fall.

To put it concretely: The opinion finds that after applying the 10% reduction, the petitioners on the volume of business in the test period would earn a profit of $7,287,209 (R. 3036), and that a reasonable profit on that volume of business would be $6,680,169 (R. 3035). So that the profit which the opinion says petitioners would earn with the reduction applied, is only $607,040 in excess of the amount which the opinion finds would have been a reasonable profit.

Each item complained of by petitioners involves more than $607,040. The adoption of the received and paid method in-

stead of the earned and incurred method, makes a difference of $10,351,324 in the tabulation of profit or loss (Plaintiffs' Exhibits 1359 and 1361 at R. 1925 and 1934). The inclusion of interest earnings from unearned premiums (investments) makes a difference of $2,301,132 (R. 3034-5). The rejection of excess commissions paid to St. Louis agents makes a difference of $2,496,715 (R. 3034-5). The rejection of war tax on Missouri premiums makes a difference of $628,123 (R. 3034-5). Likewise, the fixing of $6,680,169 as the amount of a reasonable profit, without any allowance for the reserve, makes a difference far exceeding the narrow margin by which the rate reduction order is colorably sustained.

It therefore follows, as a self-evident mathematical fact, that if any one of petitioners' contentions is sustained, the rate reduction order is confiscatory.

VIII.

While this Court will accept the construction adopted by the Missouri Supreme Court in arriving at the meaning of the rating statute, nevertheless if the statute as construed or the rate reduction order as upheld by that court deprive petitioners of property without due process of law, this court will reverse the judgment.

In his brief opposing the issuance of the writ of certiorari herein, the Superintendent argued that the Missouri rating act requires that the calculation of profit or loss be made upon the received and paid basis, and requires that interest on unearned premiums be included as income; and that since the Missouri Supreme Court has so "construed" *sic* the rating act, this court is bound to follow that construction; and that, the construction being settled, there is nothing for this court to review.

This court has held (as the Superintendent points out) that it will follow the state court's construction of state legisla-

tion; and we freely concede that proposition. The rate order of the Superintendent violated constitutional rights. Such being the case, those whose rights are infringed may complain. An action within constitutional prohibitions cannot gain strength or purge its nature by invoking as authority a statutory warrant. If that were true, statutes would be greater than the constitution.

When a law as administered by a state court is attacked because its application violates the constitution of the United States, a Federal question is presented to be decided by this court.

Myles Salt Co. v. *Iberia, Drainage District*, 239 U. S. 478 l. c. 484.

Frost v. *Railroad Commission*, 271 U. S. 583.

Reagan v. *Farmers Loan & Trust Co.*, 154 U. S. 362 l. c. 390-391.

Greene v. *Louisville & Interurban R. R. Co.*, 244 U. S. 499 l. c. 507.

Raymond v. *Chicago Traction Co.*, 207 U. S. 20.

Castillo v. *McConnico*, 168 U. S. 674.

Old Colony Trust Co. v. *Omaha*, 230 U. S. 100.

In the present case we maintain that the rating act as construed and applied by the Missouri Supreme Court violates the Fourteenth Amendment. The Federal question raised does not challenge the construction of the act, but is based upon a construction which, when applied, deprives petitioners of their property without due process. In such circumstances this court is not precluded from reviewing the judgment, but will determine questions raised under the Federal Constitution upon its own judgment of the actual operation and effect of the statute, regardless of how it is characterized by the state court.

This court has recently so decided in *Hanover Fire Ins. Co. v. Harding*, (Carr) 272 U. S. 494, l. c. 508, where the court said:

> "It is true that the interpretation put upon such a tax law of a state by its supreme court is binding upon this court as to its meaning; but it is not true that this court, in accepting the meaning thus given, may not exercise its independent judgment in determining whether, with the meaning given, its effect would not involve a violation of the Federal Constitution."

In *Standard Oil Co.* v. *Graves*, 249 U. S. 359, l. c. 394, this court said:

> "While this court follows the decisions of the highest court of a state, as to the meaning of statutes in cases of this character, the name given to the statute is not conclusive. It must be judged by its necessary effect, and if that is to violate the Constitution of the United States, the law must be declared void."

To the same effect are the following decisions:

Crew Levick Co. v. *Pa.*, 245 U. S. 292, l. c. 294.

St. Louis-Southwestern Ry. Co. v. *Arkansas*, 235 U. S. 350 l. c. 362.

Galveston Ry. Co. v. *Texas*, 210 U. S. 217 l.c. 227.

Kansas City Ry. Co. v. *Kansas*, 240 U. S. 227 l.c. 231.

Frost v. *Railroad Commission*, 271 U. S. 583.

Dahnke-Walker Milling Co. v. *Bondurant*, 257 U. S. 282 l. c. 290.

A simple answer to the Superintendent's contention is that if his acts are unreasonable, fundamentally erroneous, confiscatory and unconstitutional, (*i. e.*, the use of the received and paid method, and the application of investment earnings toward a reduction of underwriting rates, and the disallowance of legitimate expenditures actually incurred), then whether the statute sanctions or prohibits his act by its terms, his act remains unconstitutional and void, and this court has juris-

diction to so decide, regardless of how the statute has been characterized by the Missouri Supreme Court. If the statute as written is not confiscatory and unconstitutional, but if the reduction order as upheld by the Supreme Court is so, then the reduction order is likewise unconstitutional, and this court has jurisdiction to so decide.

The argument of the Superintendent to the effect that the *construction* of the state statute by the Missouri Supreme Court will be followed by this court, is not questioned, insofar as such assertion is limited to questions of *construction* only. But whether the statute, or the order, or both, as applied violate the Federal Constitution are clearly questions for this court's determination.

IX.

The decision below does not rest upon independent non-federal grounds. The federal rights asserted were of such character that no judgment adverse to petitioners could be rendered without denying them; and they were necessarily denied by the result of the opinion and judgment below.

In his brief in opposition to the granting of certiorari herein, the Superintendent argued in effect that the decision by the Missouri Supreme Court rests entirely upon non-Federal grounds broad enough to support it, and that therefore this court is without jurisdiction to review the judgment.

The principal invoked is without application here. In this case petitioner asserted rights under the Federal Constitution of such character that no judgment against petitioners on the merits could possibly be rendered without denying them. Petitioners asserted that the rate reduction order and the Rating Act as construed and applied were in certain respects confiscatory and unconstitutional, and that petitioners were thereby deprived of their property without due process of law. The

Missouri Supreme Court by its judgment upon the merits has sustained the rate reduction order as valid under the statute, thereby necessarily holding against petitioners upon the Federal questions presented. In such case the decision does not rest upon independent non-federal grounds. The Federal questions continue to be live questions in the case, and this court has jurisdiction to review them. The dissenting opinion says that rights under the Fourteenth Amendment are denied by the majority opinion. Adherence to the majority opinion in the presence of this expressed dissent is in legal effect a holding adverse to the dissenting opinion.

It is quite true the Missouri Supreme Court did not in the majority opinion *expressly refer* to the federal questions. But this is not material. That court necessarily decided the federal questions against petitioners by the result reached. Federal questions, seasonably asserted and kept alive through the proceedings below, cannot be deleted from the case by the mere failure of the Missouri Supreme Court to pass upon them in specific terms. If it were otherwise, a federal question could always be eliminated by mere silence on the part of the state court.

In *Chicago, Burlington & Quincy Railroad* v. *Chicago*, 166 U. S. 226 l. c. 231-232, this court said:

> "It is true that the Supreme Court of Illinois *did not in its opinion expressly refer* to the Constitution of the United States. But the circumstance is not conclusive against the jurisdiction of this court to reexamine the final judgment of the state court. *The judgment of affirmance necessarily denied the Federal rights thus specially set up by the defendant; for that judgment could not have been rendered without deciding adversely to such claims or right.* Those claims went to the very foundation of the whole proceeding so far as it related to the railroad company, and the legal effect of the judgment of the Supreme Court of the State was to deny them. * * * Consequently, the motion to dismiss for want of jurisdiction must be overruled, and we proceed to examine the case upon its merits." (Italics ours.)

To the same effect are the following:

Chicago, Burlington & Quincy Ry. Co. v. *Drainage Comms.*, 200 U. S. 561, l. c. 580.

West Chicago Railroad v. *Chicago*, 201 U. S. 506, l. c. 519.

Schlemmer v. *Buffalo, Rochester Ry. Co.*, 205 U. S. 1, l. c. 11.

Chicago Life Ins. Co. v. *Needles*, 113 U. S. 574, l. c. 579.

International Harvester Company v. *Missouri*, 234 U. S. 199.

Green Bay & M. Canal Co. v. *Patten Paper Co.*, 172 U. S. 58, l. c. 66-68.

McCullough v. *Virginia*, 172 U. S. 102, l. c. 116-117.

Kaukauna Co. v. *Green Bay & Canal Co.*, 142 U. S. 254, l. c. 269.

Eureka Lake Co. v. *Yuba Co.*, 116 U. S. 410.

Toledo, Etc. Ry. Co. v. *Slavin*, 236 U. S. 454.

Carondelet Canal Co. v. *Louisiana*, 233 U. S. 362.

Otis Co. v. *Lundlow Mfg. Co.*, 201 U. S. 140.

Fiske v. *Kansas*, 47 Sup. Ct. Rep. 655, l. c. 656.

The federal questions presented were fundamental in their nature, going to the very foundation of the judgment. Petitioners in several respects attacked the very basis and methods of calculation adopted by the Superintendent in arriving at profit. The majority opinion of the Missouri Supreme Court brushed aside the constitutional questions without even mentioning them, yet upheld the Superintendent's rate reduction order and methods of calculation. Obviously, the federal rights asserted were necessarily denied. This court, therefore, has jurisdiction to review the judgment.

X.

The questions which petitioners present herein are not questions of fact, but are questions of law, the decision of which this court has jurisdiction to review.

In his brief opposing the granting of certiorari herein, the Superintendent argued that all of the questions involved in this case are questions of fact, and that this court has no jurisdiction to review the Missouri Supreme Court's decision on questions of fact. The Superintendent argued that the question whether petitioners made a profit or loss was purely a question of fact, and that the Missouri Supreme Court having found in favor of the Superintendent on that issue, there is nothing left to review.

This argument entirely begs the question. While the ultimate question is whether petitioners made a profit or loss, yet before that question is reached there must be decided these vital questions: (*a*) whether the adoption of the received and paid method of calculating underwriting profit is unreasonable, fundamentally erroneous and confiscatory; (*b*) whether the application of investment earnings toward a reduction of underwriting rates is confiscatory; (*c*) whether the disallowance of excess commissions as an item of expense is unreasonable and confiscatory; (*d*) whether the disallowance of the war tax as an item of expense is unreasonable and confiscatory; (*e*) whether the fixing of eight per cent of premiums received as the amount of a reasonable profit, without making allowance for the unearned premium reserve, is unreasonable and confiscatory; (*f*) and whether the rating statute as construed and applied is in violation of the due process clause. *These questions are pure questions of law, and not questions of fact in any sense.*

If the question whether a profit or loss has been derived from a given rate structure, involving inquiry into the meth-

ods of calculation employed, is purely a question of fact (as the Superintendent argues), then this court would never have jurisdiction to review the judgment of a state court in any rate case. It would always be open to the state rate-making body to forestall the review upon the ground that the state court's judgment is conclusive because based on findings of fact. In the following cases judgments of state courts upholding confiscatory rates were reversed by this court upon the point of law above stated:

Bluefield Water Works & Improvement Company v. *Public Service Commission*, 262 U. S. 679.

State of Missouri ex rel. Southwest Bell Telephone Company v. *Public Service Commission*, 262 U. S. 276.

Northern Pacific Railway v. *Department of Public Works*, 268 U. S. 39, l. c. 44.

Ohio Utilities Co. v. *Public Utilities Commission*, 267 U. S. 359.

Vandalia Railroad Co. v. *Schnull*, 255 U. S. 113.

Northern Pacific Railway Co. v. *North Dakota*, 236 U. S. 585.

Norfolk & Western Railway Co. v. *Conley*, 236 U. S. 605.

Chicago, Milwaukee & St. P. Ry. Co. v. *Pub. Util. Comm.*, 47 Sup. Ct. Rep. 604, l. c. 606.

It is interesting to note that in *State of Missouri ex rel. Southwest Telephone Company* v. *Missouri Public Service Commission*, 262 U. S. 276, the Missouri Public Service Commission made identically the same argument as that now made by Respondent, namely, that the Missouri Supreme Court had found the rates were not confiscatory, and that this was a finding of fact which this court should not review (see 262 U. S., l.c. 280). Nevertheless, this court did review the judgment, and reversed it on the ground, among others, that

an item of legitimate expense had been unreasonably disallowed by the Commission (262 U. S., l.c. 288-9).

The adoption of an improper method of calculating underwriting profit was treated as a question of law in *Bullion* v. *Aetna Insurance Company*, 151 Ark. 519; *Sun Insurance Office* v. *Clark*, App. Cas., Law Reports, 1912, page 443; *Scott* v. *Eagle Fire Company*, 7 Paige (New York) 198; and *Hope Mutual Insurance Company* v. *Perkins*, 4 Rob. (New York) 182. The rule for ascertaining profit or loss stands in the same status as the rule for ascertaining damages, which is treated as a question of law (*Christian* v. *Irwin*, 125 Ill. 619).

In the Bullion Case (151 Ark. 519, l. c. 540), Justice Wood in his concurring opinion said:

> "Even if there had been no testimony in the record explaining the meaning of the technical term 'underwriting profit,' this court applying business principles and correct rules of accounting could have only reached the same conclusion without the aid of the testimony of insurance rate experts, that it has arrived at with such aid."

This is a clear holding that the question is one of law.

The Missouri Supreme Court expressly finds in its opinion in this case that the facts are undisputed (R. 3008-9). In such a case the only questions presented are questions of law. (*Small Co.* v. *Lamborn & Co.*, 267 U. S. 248; *Bell* v. *Carter* (C. C. A.) 164 Fed. 417; *Muskogee Land Co.* v. *Mullins*, (C. C. A.) 165 Fed. 179; *Harmon* v. *Barber*, (C. C. A.) 247 Fed. 1, l. c. 5-6; *Hammerschlag Mfg. Co.* v. *Traders Bank*, (C. C. A.) 262 Fed. 266.)

The facts being undisputed, the situation is analogous to that presented where the facts alleged in a petition are admitted by demurrer. In such a case this court has said in *Truax* v. *Corrigan*, 257 U. S. 312, l. c. 324:

> "The facts alleged are admitted by the demurrer, and in determining their legal effect as a deprivation of plain-

tiffs' legal rights under the Fourteenth Amendment, *we are at as full liberty to consider them as was the State Supreme Court. Mackay* v. *Dillon*, 4 How. 421; *Dower* v. *Richards*, 151 U. S. 658, 667. Nor does the court's declaration that the statute is a rule of evidence bind us in such an investigation. *Bailey* v. *Alabama*, 219 U. S. 219, 239; *Chicago, Milwaukee & St. Paul Ry. Co.* v. *Minnesota*, 134 U. S. 418; *Mugler* v. *Kansas*, 123 U. S. 623, 661; *Corn Products Refining Co.* v. *Eddy*, 249 U. S. 427, 432. In cases brought to this court from state courts for review, on the ground that a federal right set up in the state court has been wrongly denied, and in which the state court has put its decision on a finding that the asserted federal right has no basis in point of fact or has been waived or lost, this court as an incident of its power to determine whether a federal right has been wrongly denied, may go behind the finding to see whether it is without substantial support. If the rule were otherwise, it almost always would be within the power of a state court practically to prevent a review here." (Italics ours.)

To the same effect, see *Kelley* v. *Rhoads*, 188 U. S. 1, l. c. 5.

The Missouri Supreme Court has not found *the facts* against the petitioners. But even if it had done so, it has been clearly ruled by this court in a number of decisions that where it is necessary for this court, in passing upon a federal right asserted, to analyze the facts in order to determine whether that which purports to be a finding of fact is so interwoven with a question of law as to be in substance a decision of the latter, this court will go into the facts for that purpose.

In the case of *Kansas City Southern Ry. Co.* v. *C. H. Albers Commission Co.*, 223 U. S. 573, 591, Mr. Justice Vandeventer, in the course of a decision in a garnishment case, said:

> "While it is true that upon a writ of error to a state court we cannot review its decision upon pure questions of fact, but only upon questions of law bearing upon the Federal right set up by the unsuccessful party, it equally is true that we may examine the entire record, including the evidence, if properly incorporated therein, to deter-

mine whether what purports to be a finding upon questions of fact is so involved with and dependent upon such questions of law as to be in substance and effect a decision of the latter."

In the case of *Creswill* v. *Grand Lodge, Knights of Pythias*, 225 U. S. 246, 261, Mr. Chief Justice White, in a case involving a claimed infringement of the name of a fraternal order and the copyright of its insignia and emblems, says:

"While it is true that upon a writ of error to a state court we do not review findings of fact, nevertheless two propositions are as well settled as the rule itself, as follows:

(*a*) that where a Federal right has been denied as the result of a finding of fact which it is contended there was no evidence whatever to support, and the evidence is in the record, the resulting question of law is open for decision; and,

(*b*) that where a conclusion of law as to a federal right and a finding of fact are so intermingled as to cause it to be essentially necessary, for the purpose of passing upon the federal question, to analyze and dissect the facts, to the extent necessary to do so, the power exists as a necessary incident to a decision upon the claim of denial of the federal right."

The same principle has been applied in rate cases and is supported by the following decisions:

Norfolk & Western Ry. Co. v. *West Virginia*, 236 U. S. 605, 609-610.

Oregon Railroad and Navigation Co. v. *Fairchild*, 224 U. S., l.c. 528.

Southern Pacific Co. v. *Schuyler*, 227 U. S. l.c. 611.

Wood v. *Chesborough*, 228 U. S., l.c. 678.

Acme Harvester Co. v. *Beekman Lbr. Co.*, 222 U. S., l.c. 305-6.

Clearly this record presents federal questions of law, which this court has jurisdiction to review.

XI.

Petitioners have substantial property in Missouri, and they are entitled to invoke the protection of the Fourteenth Amendment.

In his brief opposing the granting of certiorari herein the Superintendent argued that petitioners have no property in Missouri, and that they are not entitled to the protection of the Fourteenth Amendment. He said in his brief (at p. 20) that petitioners "have no property in the state, but simply exchange contracts of insurance for money."

In this statement counsel overlook the fact that some of the petitioners are Missouri companies with their assets there.

Apparently the position of the Superintendent is that even if the rate reduction order is confiscatory, so that petitioners are required to write insurance at less than cost, yet the Fourteenth Amendment affords them no protection against such confiscation. This argument discloses the genuine viewpoint of the Superintendent, which is sealed with the approval of the Missouri Supreme Court, namely, that the insurance companies have no rights which Missouri is bound to respect; and that under the guise of regulation Missouri may require the writing of insurance at rates productive of income insufficient to meet outgo.

Of course, if this may constitutionally be done, then the insurance companies could be required to write their policies for mere nominal considerations, or for no consideration at all; for this would only be carrying to a greater degree the same principle, that the insurance companies have no rights which Missouri is required by the Fourteenth Amendment to recognize.

We had supposed this notion had long since been dispelled by the decisions of this court in *Terral* v. *Burke Construction Co.*, 257 U. S. 529; *Fidelity & Deposit Co.* v. *Tafoya*, 270 U.

S. 426; *Carroll* v. *Greenwich Insurance Co.*, 199 U. S. 401, l. c. 409, and similar decisions.

Petitioners have established their agency plants and business in Missouri at great cost and expense (R. 1531-2, 749). These agency relations and established business are of great pecuniary value. The actual salable value of agency plants is shown to be twenty-five per cent of the amount of unearned premiums (R. 1760-1, 1802-3). The unearned premiums in Missouri at the end of the five-year test period were $17,061,209 (plaintiffs' Exhibit 1359 at R. 1925). Twenty-five per cent of this sum is $4,265,302, which was the value of petitioners' agency plants in Missouri at the end of the test period as shown by the evidence.

In the recent case of *Hanover Fire Ins. Co.* v. *Harding*, (Carr) 272 U. S. 494, this court has decided that the good will and agency plants of an insurance company constitute property within the protection of the Fourteenth Amendment. In that case this court said:

> "In the present case there is no such permanent investment in the state of Illinois as there was in the *Greene Case* in Alabama, but the averments of the bill show that the complainant has from year to year secured renewal of its license in the state of Illinois, and has through many years past built up a large good will in the state of Illinois and has associated with a large number of agents in the various counties of the state, whose connection with it has resulted in a large and profitable business to the complainant, and that it has large numbers of records containing information respecting its policyholders, the character and nature of their policies and other records, the value of all of which would be destroyed if excluded from the state by a denial of the equal protection of the laws."

That "good will" alone is property and subject to protection as such is settled by all of the authorities.

Crutwell v. *Lye*, 17 Vesey 335 (opinion by Lord Eldon).

Washburn v. *Natl. Wall Paper Co.*, 81 Fed. 17.
See v. *Heppenheimer*, 61 Atl. (N. Y.) 843.
Rowell v. *Rowell*, 99 N. W. (Wis.) 478.
Godley v. *Crandall*, 139 N. Y. Supp. 236.
Milling Co. v. *Hanebrink*, 247 Mo. l.c. 221.
Clabaugh v. *Heibner*, 236 S. W. 396.
Bettendorf v. *Bettendorf*, 190 Iowa 83.
Lindeman v. *Rusk*, 125 Wis. 210.
Langer v. *Fargo Merc. Co.*, 186 N. W. 104.

This Court in *Des Moines Gas Co.* v. *Des Moines*, 238 U. S. 153, l. c. 165, said:

> " 'Going value' or 'going concern value,' *i. e.*, the value which inheres in a plant where its business is established as distinguished from one which has yet to establish its business has been the subject of much discussion in rate-making cases before the courts and commissions. Many of those cases are collected in Whitten on 'Valuation of Public Service Corporation,' Secs. 550-569, and the supplement to the same work, Secs. 1350-1385. That there is an element of value in an assembled and established plant, doing business and earning money, over one not thus advanced, is self-evident. *This element of value is a property right* * * *." (Italics ours.)

In *Denver* v. *Denver Water Co.*, 246 U. S. 178 l. c. 192, and *McCardle* v. *Indianapolis Water Co.*, 272 U. S. 400, this court reaffirms the same principle. Also in *Dorchy* v. *State of Kansas*, 272 U. S. 306, this court says:

> "The right to carry on business—be it called liberty or property—has value."

If the Superintendent's rate reduction order violates the Fourteenth Amendment in that it prevents the companies from doing business at a reasonable profit, then that order is no more binding on the companies than was the New Mexico statute involved in *Fidelity & Deposit Co.* v. *Tafoya*, 270 U. S. 426, 46 Sup. Ct. Rep. 331, 70 L. Ed. 664, which provided for the suspension of the licenses of insurance companies upon

failure to comply with a statute held to be violative of the Fourteenth Amendment. In that case deprivation of property was complained of by a foreign insurance company, and this court did not hesitate to give the insurance company the protection of the Fourteenth Amendment.

In *Truax* v. *Corrigan*, 257 U. S. 312 l. c. 328, this court has held that to injure one's established business is to deprive one of property within the meaning of the Fourteenth Amendment.

Petitioners are not law violators or outlaws. They are expressly chartered, licensed and permitted to do business in Missouri. Yet the Superintendent says that so far as the Fourteenth Amendment is concerned the State of Missouri can compel them to do business without profit, because their established business and agency plants (worth over $4,000,000) are not property. The absurdity of this contention seems evident. The Superintendent in effect charges that petitioners' established business exists only in the making of contracts, without tangible property and that therefore the capital and surplus of the petitioners' stockholders may (so far as the Fourteenth Amendment is concerned) be confiscated to furnish cheap insurance to the citizens of Missouri.

We respectfully submit that petitioners have substantial property in Missouri; and that the Fourteenth Amendment protects them from the confiscation of this property without due process of law.

IN CONCLUSION.

The merits of this case should strongly appeal to this court. The questions involved are federal questions. They are of tremendous importance in Missouri and the numerous other states having statutes authorizing the regulation of insurance rates (R. 1128). As stated in the dissenting opinion (R. 3037):

> "The questions involved are not only of present moment, but as time goes on will become increasingly important."

These questions have never been passed upon by this court. It is inevitable that sooner or later they must be decided here. This case presents them squarely.

Upon the principal question presented, the Supreme Court of Arkansas in *Bullion* v. *Aetna Insurance Co.*, 151 Ark. 519, has decided in favor of the earned and incurred method, while the Missouri Supreme Court in the instant case holds *contra*. The same questions will inevitably arise in other states having statutes authorizing the regulation of insurance rates (R. 1128). It is appropriate that this court should authoritatively settle these questions.

If the rate reduction order here involved should be finally sustained, the petitioners would be required to return to policyholders in Missouri approximately $8,000,000, representing the difference between the rates at which policies have been issued since November 15, 1922, and the rates fixed by the reduction order. By stipulation the old rates have been collected and bond given to refund the excess if the order should be finally sustained (R. 1640-2).

If the Superintendent's order should finally be sustained, petitioners would suffer great loss, not only in the amount of

this gigantic refund, but in the further fact that they would be compelled in the future either to do business in Missouri at grossly inadequate and confiscatory rates, or to cease doing business in the State and thereby to lose their agency plants and established business, which are of great pecuniary value (*Hanover Fire Ins. Co.* v. *Carr*, 47 Sup. Ct. Rep. l.c. 182-183).

The Supreme Court of Missouri has decided the federal questions involved in a way plainly not in accord with applicable decisions of this court upon closely analogous questions.

We respectfully ask that the judgment of the Missouri Supreme Court be reversed.

Respectfully submitted,

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